



Public School Employees' Retirement System

Response to

Commonwealth of Pennsylvania

Department of the Auditor General

Performance Audit Report

Submitted on May 19, 2017



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

May 19, 2017

Honorable Eugene DePasquale
Department of Auditor General
Room 229 Finance Building
Harrisburg, PA 17120-0018

RE: Public School Employees' Retirement System (PSERS)
Performance Audit Report
Management Response

Dear Auditor General DePasquale:

The attached Management Response is offered to the Performance Audit Report – Draft Findings – dated May 2017, for inclusion with the Final Report. We appreciate the opportunity to provide this response on behalf of the Board of Trustees of PSERS to the various findings and recommendations.

PSERS Management is very pleased to note that the Report does not include any findings that PSERS is in violation of any statute, Retirement Code provision, regulation, Management Directive, By-law provision, or other policy, relating to any of the areas within the scope of the audit. Moreover, the Report does not make any specific finding of any fraud, waste or abuse of public funds relating to any of the areas within the scope of the audit.

With respect to the important Pension Forfeiture Act (Act), the Audit Team reviewed PSERS processing of 106 possible forfeiture cases during the audit period and sampled 20 cases, concluding that PSERS properly determined all 20 cases in accordance with the Act. PSERS Management agrees with other recommendations to improve its ability to discover possible forfeiture cases as early as possible and to strengthen our written procedures.

Regarding PSERS' investment operations, the Audit Report properly found and opined that:

- PSERS' reporting and transparency practices are commendable and surpass peer organization practices;
- PSERS appropriately manages investment expenses;
- PSERS' attention to diversification, risk management and asset allocation – “the single most important investment decision that pension trustees can make” (Issue Area 5 of

- Report) – are all adequate and reasonable and recommends that PSERS continue doing what we are doing in those areas;
- Recommendations in Issue Area 3 all deal with strengthening and enhancing current practices in the areas of transparency, fee negotiation and monitoring of managers.

Many of the other findings and recommendations are more procedural and administrative in nature. In most cases, the Audit Team points out possible “best practices” from other public funds or from academic research and recommend that PSERS consider adoption of the “best practices”. Management accepts these findings and recommendations in the spirit of continuous improvement of the administration of the System.

Management would be remiss if we did not comment on certain language included in Issue Area 2 which was inexplicably inserted in the Draft Report following the conclusion of the official Exit Conference on May 18, 2017. The addition of the gratuitous assertion that PSERS’ use of external active investment management is “woefully unfair to the taxpayers” is baseless and inconsistent with the Government Accounting Standards cited in the Report. We draw your attention to the Management Response at Issue Area 2 (page 6) and Finding 2.3 (pages 6-9) for factual rebuttal of the assertion. Sadly, the post-exit conference addition of this politically-motivated invective places a stain on an otherwise professional performance audit and the hard and capable work of the audit team.

Thank you for the opportunity to append this Management Response to your Report.

Very Truly Yours,



GLEN R. GRELL
Executive Director
PSERS

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Issue Area 1 – PSERS failed to assess and document the investment knowledge and skills of each trustee to demonstrate the Board collectively possesses the abilities to oversee prudent investment decisions.

PSERS Management disagrees with Issue Area 1.

This Area does not appear to include specific “findings” (as other Areas do); however, the report includes four headings which make interrelated criticisms of the Board, which warrant responses:

1. There are no prerequisites to becoming a Board trustee.
2. The Board does not assess the investment education needs of each trustee.
3. There are no requirements for continual educational sessions.
4. The Board’s tracking of trustee attendance at educational events is weak.

Under the PSERS Retirement Code (PSERC), PSERS Trustees (Trustees) are elected or appointed to bring diverse skills and experiences to the Board and to make certain that the points of view and priorities of various stakeholders (e.g. certified members, non-certified members, annuitants, school boards and administrators, taxpayer’s, public, legislature and administration) have a voice among the Board. Trustees are volunteers and part-time and they are not compensated for their time and expertise, beyond reimbursement of expenses. By design, they are not the day-to-day managers of the System. Rather, Trustees provide strategic direction, establish policies and monitor performance in diverse areas of investment of funds, pension benefits administration, health insurance plan administration, prescription drug benefit program administration, and related functions.

The Audit Report acknowledges there is no basis in the PSERC nor in fiduciary and governance practices to establish minimum qualifications to be a PSERS Board Member, yet it faults PSERS for not imposing such requirements. The Audit Report cleverly avoids asserting that PSERS Board Members are not qualified by saying PSERS failed to assess and document their expertise.

The biographical information provided to the Auditor General’s Office showed the PSERS Board is comprised of an accomplished and diverse array of individuals. It is hard to understand how the Audit Team concluded that the following board composition does not collectively possess the skills and knowledge to provide oversight of the investment portfolio and the System.

Board Member(s)	Qualifications
Governor Appointee A	<ul style="list-style-type: none"> - Former President, CEO & Treasurer of the Pennsylvania Bankers Association - Chairman, Pennsylvania Banking and Securities Commission - Commissioner, Pennsylvania Banking and Securities Commission - Treasurer and Partner, Tri-County Investors
Governor Appointee B	<ul style="list-style-type: none"> - Senior Counsel with an international law firm specializing in Global, Corporate and Securities practices - Former US Ambassador - Trustee, University of Pennsylvania - Member, Board of Visitors, Temple University Beasley School of Law - Overseer, University of Pennsylvania School of Nursing - Judge Pro Tempore, 1st Judicial District of Pennsylvania - Member, Federal Judicial Nomination Panel
Member elected by members of the PA Public School Boards	<ul style="list-style-type: none"> - MBA in Finance & Accounting - Retired CPA - Retired investment banker
Annuitant of the System	<ul style="list-style-type: none"> - Served on the PSERS board since 1994 and has been the Chairman of the PSERS board since 2007 - Served on the Board of Directors for the PA State Education Association - Served on the Executive Board for the National Council on Teacher Retirement (NCTR) and Past-President of NCTR

Two members appointed by the President Pro Tempore of PA Senate	<ul style="list-style-type: none"> - One member serves as the Chairman of the Senate Appropriations Committee and is a CPA - One member served as a senior development advisor where he managed a \$35 million portfolio of community development loans and investments
Two members appointed by the Speaker of the House from the PA House of Representatives	<ul style="list-style-type: none"> - One member is the Chairman of the House Appropriations Committee - One member is lawyer and has taught courses in economics, personal finance and business law
Three Ex-Officio Members	<ul style="list-style-type: none"> - One member has served as a senior manager for the Pennsylvania Bankers Association - The other two ex-officio members have experience in public education
Three Active Certified Members	<ul style="list-style-type: none"> - Two of the active certified members have a master's degree and all of active certified members have a bachelor's degree - These members have a combined experience of 65 years serving as teachers in the public school system

In the area of Board Member Education, the Audit Report acknowledges (1) there is no basis in the PSERC to impose continuing education requirements on the Board; (2) the PSERS staff provides a thorough new member orientation program to in-coming Trustees; (3) the PSERS staff offers a wide range of educational programs to Trustees. There is no criticism of the quantity or quality of Board Education programs. Rather, the basis of the criticism has to do with the quality of our attendance-taking skills.

In fact, Trustees have available a wide range of supplemental education opportunities, internal and external, most notably offered through Pennsylvania Association of Public Employee Retirement Systems and National Council on Teacher Retirement (NCTR). The NCTR training includes approximately 23 hours of instruction at NCTR's Annual Meeting and a three day workshop, which alternates annually between the Harvard Kennedy School and the University of California Berkeley Center for Executive Education. Documents provided to the Audit Team demonstrated that Trustees attended the following training events during the 2016 calendar year alone:

Board Member(s)	Conferences Attended: (There were 4 conferences available to attend.)	Board Education presented during board meetings: (There were 4 educational sessions held.)
Governor Appointee A	0	3
Governor Appointee B	0	2
Member elected by members of the PA Public School Boards	1	4
Annuitant of the System	4	4
Member appointed by President Pro Tempore of PA Senate representing the Majority party (or their designee)	1	3
Member appointed by President Pro Tempore of PA Senate representing the Minority party (or their designee)	1	4
Member appointed by the Speaker of the House from the PA House of Representatives for Majority party (or their designee)	0	4
Member appointed by the Speaker of the House from the PA House of Representatives for Minority party (or their designee)	2	4
Secretary of Education (or their designee)	0	4
Treasurer (or their designee)	0	1

Executive Director of the PA School Boards Association	1	4
Active Certified Member A	2	4
Active Certified Member B	3	4
Active Certified Member C	4	3
Active Non-Certified Member	3	4

Finally, the Audit Team’s primary research tool was a survey of current and previous Trustees – yet the report misstates the results of the survey by focusing on the very few negative or critical responses while neglecting to include the overwhelmingly favorable responses, particularly in the areas of board member skills; new member orientation; completeness and timeliness of investment information provided to the Board; sufficiency of conflict of interest procedures and other key areas.

For example in the area of sufficiency of knowledge and experience, 24 of 25 respondents consistently “Agreed” or “Strongly Agreed”, yet the Audit Report points out the one respondent who felt he or she did not have sufficient knowledge and experience. Out of 29 separate inquiries, only one category had 4 respondents who “Disagreed” or “Strongly Disagreed” with the positive statement. By any reasonable standard, the survey responses were overwhelmingly positive, yet a reader of the Audit Report would draw a negative conclusion.

Recommendations for Issue Area 1

Recommendations to General Assembly:	PSERS Management Response:
1. Include a minimum amount of investment knowledge or experience the Board, as a collective whole, must possess in order to guide informed investment decisions and promote effective oversight of investment operations.	This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
2. Require that all new board members or designees be mandated to attend a board orientation session when appointed to the board.	This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
3. Mandate a minimum amount of continuing education or training each Board member/designee must obtain annually, specifying the minimum amount of hours of training and the core subject matters the trainings must encompass.	PSERS disagrees that Trustees do not have ample opportunities to enhance their skills and competencies and notes that most Trustees take advantage of the opportunities in order to better serve PSERS. This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
4. Clarify that designees are subject to the same mandated training and education as members.	This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
5. Include a clarification of Board trustees’ fiduciary duties and the standard to which they are subject under Section 8521(a) of the PSERC, 24 Pa.C.S. § 8521(a).	PSERS disagrees. Section 8521(a) of the Retirement Code sets forth the prudent investor standard which the Board must apply in making investment decisions. That investment standard is clear. Section 8521(e) places the Board in a fiduciary relationship to the members of the system regarding the investments and disbursements of the fund and prohibits the Board members from profiting with respect to the fund. The fiduciary relationship gives rise to the common law standards to

	<p>which a fiduciary is bound, such as the duty to act primarily for the benefit the members of the system in accordance with all applicable laws. The Board is thus prohibited from making investments that are imprudent or speculative in nature due to the application of subsection (a), and are bound by general fiduciary standards due to the application of subsection (e). While Section 8521(e) sets forth a number of factors that the board may consider in making investment decisions, such as promoting the general welfare of the Commonwealth and its citizens, these other factors must otherwise be consistent with the investment standard and the general fiduciary standards. Common law fiduciary duties are numerous and nuanced, and an attempt to clarify them via statute would necessarily limit them.</p> <p>Implementation Plan: N/A</p>
<p>Recommendations to PSERS:</p>	<p>PSERS Management Response:</p>
<p>6. Obtain and maintain biographies of each Board member/designee to evidence educational, career, or other experience related to key Board processes, including institutional investments.</p>	<p>PSERS will endeavor to implement the best practice.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>7. Include Board member biographies on the PSERS website to increase transparency.</p>	<p>PSERS will endeavor to implement the best practice.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>8. Establish and implement provisions within the Board's Education Policy to require:</p> <ul style="list-style-type: none"> a. Each Board member/designee complete a self-evaluation, on a Board-provided form, of their educational needs at least annually to assist in identifying topics for training. b. The Board to determine the subject matters addressed at education sessions and to what extent each topic needs to be discussed. c. A minimum amount of mandatory education or training each Board member/designee must obtain each year, specifying the minimum amount of hours of training and the core subject matters the trainings must encompass. 	<p>PSERS responses are as follows:</p> <ul style="list-style-type: none"> a. PSERS will propose revisions to the Board Education Policy. <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p> <ul style="list-style-type: none"> b. PSERS will propose revisions to the Board Education Policy. <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p> <ul style="list-style-type: none"> c. PSERS will consider mandating in the By-laws or Education Policy a minimum amount of hours of training for each member and designee, but questions the authority to impose consequences if members and/or designees do not abide by the training requirement. Any such revision should take into consideration those Board Members, by their profession, who routinely take continuing education courses, many of which benefit their service as a Trustee. For example, one Trustee reports earning 240 hours of continuing education over the past three years, the vast majority of which are applicable to his service as a Trustee.

<p>d. The Board Liaison document and retain when each new Board member/designee completes the new member orientation program.</p> <p>e. The Board Liaison track every educational session attended by the Board member/designee noting the length of the training in hours and the subject matter of each session.</p>	<p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p> <p>d. PSERS has already initiated this practice.</p> <p>Implementation Plan: Resolved</p> <p>e. PSERS has already initiated this practice.</p> <p>Implementation Plan: Resolved</p>
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Issue Area 2 – PSERS’ management of investment expenses within its asset allocation strategy/policy appears standard however woefully unfair to the taxpayers. PSERS should take a leadership role in the public pension sector by continuing to improve its reporting of investment expenses and fund performance.

The Audit Report cites the DAG conducted their audit under the Government Auditing Standards (GAS), December 2011, issued by the Comptroller General of the United States, United States Government Accountability Office, Washington D.C. Section 1.19 of GAS, states “The credibility of auditing in the government sector is based on auditors’ objectivity in discharging their professional responsibilities. Objectivity includes independence of mind and appearance when providing audits, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest.” We question the objectivity and impartiality with respect to the statement “woefully unfair to the taxpayers”, which was not included in the first 2 draft reports. This is an opinion, not a fact.

Findings for Issue Area 2

Department of the Auditor General (DAG) Findings	PSERS Management Response:
<p>Finding 2.1 – Although PSERS’ reporting of investment expenses surpasses its peer public pension systems, additional disclosure improvement can still be made.</p>	<p>Agreed. PSERS currently reports all of its investment expenses, including management fees, in accordance with accounting principles generally accepted in the United States of America. PSERS is always striving to be fully transparent on all investment related expenses. PSERS currently requests that all private fund investment managers report quarterly data utilizing the ILPA (Institutional Limited Partners Association) Reporting Template. This template breaks out the fund fees and expenses in detail. We will provide more detailed fund fees and expenses once all the private fund managers update their reporting systems to comply with this requirement.</p>
<p>Finding 2.2 – PSERS’ reporting of fund performance is comprehensive, but does not directly or clearly show the true costs associated with the investment returns.</p>	<p>Agreed. When entering new contracts with private investment managers, PSERS will require them to report quarterly data utilizing the ILPA template, which will provide detailed fund fees and expenses.</p>
<p>Finding 2.3 – PSERS’ management of investment expenses within its asset allocation policy appears standard, yet woefully unfair to taxpayers.</p>	<p>We strongly disagree with the unsubstantiated and untrue statement “...yet woefully unfair to taxpayers.” The beneficiaries directly (and taxpayers indirectly) over the past 17 years benefited by an additional \$12.1 billion in incremental performance that otherwise would not have been achievable without active management. For every \$1 spent on investment management fees during this 17 year period, active managers returned \$3 in excess performance over their benchmarks. PSERS hires top tier investment managers for top tier performance because the beneficiaries (and taxpayers) deserve the best. Hiring the second or third best may be penny wise, but it is pound foolish as those managers generally don’t deliver. Even though competition is intense for top tier investment managers among other pension plans, sovereign wealth funds, endowments and foundations, and other investors, PSERS continues to aggressively negotiate fees to obtain a fair, equitable agreement with these investment managers. From PSERS viewpoint, the beneficiaries, and taxpayer by extension, are \$12 billion better off today relative to cheaper, passive alternatives.</p>

Table 10.2 on page 51 of our Fiscal Year 2017-18 Budget Report to the House Appropriations Committee contains these figures and is reproduced below.

Table 10.2 demonstrates that over the past 17 fiscal years, on average, every dollar PSERS has spent in investment fees and expenses has resulted in investment earnings of \$3.05 above the Policy Benchmark's dollar returns.

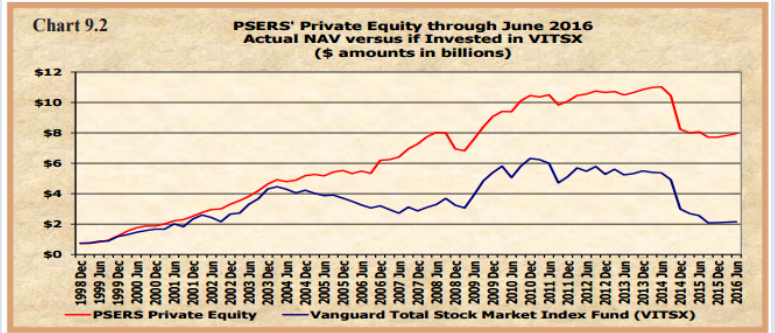
Table 10.2 PSERS' Investment Earnings over Policy Benchmark
Fiscal Years Ended June 30
(Dollar Amounts in Millions)

<i>Fiscal Year</i>	<i>Total Investment Expenses*</i>	<i>PSERS' Net Return over Policy Benchmark (AFTER Payment of all Expenses)</i>	<i>PSERS' Investment Earnings over Policy Benchmark Net of Total Investment Expenses*</i>	<i>\$1 of Investment Expenses Translates into \$\$\$ in Excess Earnings</i>
2016	\$ 416	(0.71)%	\$ (339)	\$ 0.19
2015	455	1.02%	497	2.09
2014	482	2.74%	1,519	4.15
2013	558	2.28%	1,243	3.23
2012	481	1.45%	900	2.87
2011	515	2.81%	1,573	4.05
2010	522	3.72%	1,754	4.36
2009	478	(5.87)%	(3,131)	(5.55)
2008	399	(0.98)%	(618)	(0.55)
2007	314	7.45%	2,360	8.52
2006	211	3.30%	1,635	8.75
2005	193	2.33%	1,090	6.65
2004	191	3.33%	1,388	8.27
2003	179	(0.42)%	(141)	(0.21)
2002	163	0.57%	319	2.96
2001	144	2.27%	1,200	9.33
2000	125	1.85%	934	8.47
Total	\$ 5,826		\$ 12,183	\$ 3.05

*Dollar amounts in millions.

A more specific example of where some of this excess return is coming from is Private Equity. Private Equity managers invest in private companies not available for most individuals to invest in. Private Equity is also an expensive asset class relative to a passive public equity index. In fact, the standard rate for Private Equity is a 2% management fee plus 20% of the returns generated (although PSERS has been generally able to negotiate much better fee terms). A passive low cost index costs less than 0.10%. In fact, for PSERS the costs are even lower since we manage our indexes internally. Chart 9.2 on page 43 of our Fiscal Year 2017-18 Budget Report to the House Appropriations Committee contains the performance of our Private Equity program, net of all fees and costs (net of 2% management fee and 20% of the profits) versus the performance of a similar amount of capital invested in the Vanguard Total Stock Market Index Fund (VITSX) from December 1998 through June 2016:

Chart 9.2 tracks the performance of PSERS Private Equity program versus the performance of the Vanguard Total Stock Market Index Fund from December 1998 through June 2016. PSERS has been able to generate almost \$6 billion in incremental value, net of all fees and costs, versus the passive, low cost index approach to equity investing.



PSERS Private Equity program outperformed VITX by around \$6 billion, net of the management fee and profit share. This \$6 billion accrued to the benefit of the beneficiaries (and, indirectly, the taxpayer). We could have saved a lot in fees, but we would have given up even more in performance. In the end, the taxpayer would have been at a disadvantage if we didn't have that excess performance.

PSERS has a professionally managed investment program designed to obtain the highest, net of fee, investment performance within appropriate risk constraints based on the financial circumstances facing PSERS. PSERS hires numerous top performing active investment managers that we believe will exceed the performance of passive alternatives, net of all fees and costs. Will all managers succeed? Of course not, which is why we assemble a diversified stable of managers. As shown above, this stable of managers has added significant value over time. This long history of added value also shows that PSERS has a proven talent for finding the better managers. For asset classes where we don't think active managers can add value, we will use low cost passive exposures, such as we do in U.S. equities.

Diversification of the portfolio, including diversification of asset classes and diversification of investment managers, is in the beneficiaries' and taxpayers' interests, as diversification helps PSERS better survive market stress and difficult conditions that are sure to come again at some point in the future. Many of the asset classes that add to our diversification do not have passive alternatives, so active management is the only option. However, given our size, expertise, and access to top tier managers, we have had success in selecting active managers in these alternatives which makes them invaluable additions to our portfolio.

PSERS hears the drum beat for lower fees and will continue to aggressively negotiate deals with top tier investment managers who we believe provide us the best opportunity to generate attractive risk-adjusted, net of fee returns relative to passive alternatives. PSERS is proud of its track record of generating an additional \$12 billion over the past 17 years, net of all fees and costs. While the money management industry ("Wall Street") is an easy target, let's not forget that the investment managers

	<p>hired by PSERS have collectively added value directly to the beneficiaries and indirectly to the taxpayer.</p> <p>We do agree with the finding “PSERS’ management of investment expenses within its asset allocation appears standard...” PSERS appreciates the acknowledgement that our strategic approach to key decision-making appears reasonable and that we minimize investment expenses within our asset allocation policy, specifically when deciding to use internal vs. external managers and the use of an active vs. passive strategy.</p>
<p>Recommendations for Issue Area 2</p>	
<p>Recommendation to Governor’s Office of Administration:</p>	<p>PSERS Management Response:</p>
<p>1. Increase PSERS’ Investment Office complement to allow for increased internal management of investments and lessen the multi-million dollar fees paid to external investment managers.</p>	<p>This recommendation is directed to the Office of Administration and no response is required from PSERS.</p> <p>Implementation Plan: N/A</p>
<p>Recommendations to PSERS:</p>	<p>PSERS Management Response:</p>
<p>2. Report all investment expenses, including management fees, performance fees, fund expenses, and portfolio-company charges, in its Comprehensive Annual Financial Reports, other reports, and public website.</p>	<p>PSERS currently requests that all private product investment managers report quarterly data utilizing the ILPA (Institutional Limited Partners Association) Reporting Template. The template breaks out the fund fees and expenses in detail. PSERS has gotten a very good response from our private product investment managers but not yet 100%. The primary reason that we haven’t yet gotten 100% adoption is that some managers are still updating their reporting systems in order to be able to comply. PSERS currently reports all of its investment expenses, including management fees, in accordance with accounting principles generally accepted in the United States of America. An annual audit of the System by an independent certified public accounting firm is required by the Retirement Code. PSERS has received an unmodified opinion on the annual financial statements from the System’s auditors every year. In addition, PSERS’ Comprehensive Annual Financial Report has met the guidelines necessary to be awarded the GFOA Certificate of Achievement for Excellence in Financial Reporting for 34 consecutive years.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>3. Contractually require investment managers to distinctly identify and report all investment fees and expenses incurred by PSERS.</p>	<p>PSERS has made using the ILPA Reporting Template a mandatory side letter term in all private investment manager contracts for all private investments approved by the Board beginning May 5, 2016.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>4. Report investment performance on both a gross-of-fee and net-of-fee basis in its Comprehensive Annual Financial Reports, other reports, and public website.</p>	<p>PSERS will explore the feasibility of reporting a gross-of-fee return. PSERS has historically reported a net-of-fee return since staff and the consultant knew the asset values remaining were net of all fees and costs, even if the fees and costs were not separately identified and this represents the true realized return of the plan. Calculating a gross-of-fee return is more complicated in a multi-asset class fund such as PSERS where some assets are held in LP fund structures which report their net asset value (NAV) net of certain fees and expenses which are implicit to the fund’s reported market value. In fact, we believe</p>

	<p>most funds that calculate a gross-of-fee return really report a modified gross-of-fee return which is only partially gross of fee and still reflects performance net of some fees and expenses embedded in these alternative asset class (PSERS used to present a modified gross-of-fee return about a decade ago which excluded alternative investment fees and costs). To calculate gross-of-fee returns, the net-of-fee returns have to add back cash flows from fee payments (depending on how an organization defines what a fee is and whether or not it has been separately captured). Even with this knowledge, calculating a gross-of-fee return can be complicated by whether or not the fee payment came from the corpus or paid through some other source (i.e., fee payment through unallocated cash). Timing of those fee payments also has to be factored into the calculation. Obtaining true gross of all fee NAVs for assets held in alternative LP fund would be very difficult since these funds do not report gross and net NAVs. Finally, creating a comprehensive gross-of-fee return history would be nearly impossible and very costly. All of this creates a significant burden on the staff and consultant to gather a significant amount of data without a commensurate benefit.</p> <p>Implementation Plan: PSERS will explore the feasibility and staff resources required for reporting a gross-of-fee return.</p>
<p>5. Report investment performance on time periods greater than ten years to coincide with its long-term investment strategies.</p>	<p>PSERS will endeavor to include time period longer than ten years to coincide with its long-term investment strategies.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>6. Continue to advocate increasing the number of investment professionals at PSERS to allow for increased internal management of investments and lessen the multi-million dollar fees to external investment managers.</p>	<p>Strongly Agreed.</p> <p>Implementation Plan: PSERS Management will continue to request additional investment professional positions.</p>

Issue Area 3 – PSERS failed to document its investment manager fee negotiations and lacked adequate written procedures for monitoring manager performance.

Findings for Issue Area 3

DAG Findings	PSERS Management Response:
Finding 3.1 – PSERS appears to have properly procured investment consultants in accordance with its written procedures which are consistent with DGS' <i>Procurement Handbook</i> .	Agreed. PSERS appreciates the acknowledgement that PSERS appears to have properly procured its investment consultants in accordance with written procedures that are consistent with DGS' Procurement Handbook.
Finding 3.2 – PSERS failed to document its investment manager fee negotiations.	Agreed, in part. PSERS does actively and successfully negotiate fees, but documentation of negotiations may be inconsistent. PSERS will endeavor to document all fee discussions and negotiations. Currently, the outcome of fee negotiations is documented in both presentations to the Board as well as the contractual agreements with the investment managers. PSERS has put in place additional procedures to document discussions and negotiations between PSERS and its external managers.
Finding 3.3 – PSERS' written procedures for monitoring investment managers need to be strengthened.	Agreed. One hurdle has been a shortage of staff. PSERS simply did not have adequate staff to fully lay out and document all the procedures it uses. However, with the hiring recently of additional staff, PSERS believes it can fully satisfy this recommendation in the relatively near future.

Recommendations for Issue Area 3

Recommendations to PSERS:	PSERS Management Response:
1. Adopt an investment fee policy which details the measures and techniques to use to obtain lower fees, such as determining what fees similar investors are paying and making these fee comparisons part of the negotiation process.	<p>Consistent with this recommendation, in 2016 PSERS established a number of committees, including the Fee Committee and Allocation Implementation Committee, to, among other things, more formally and systematically negotiate and document fee structures across all of its external managers. The key policy objective for these committees is to implement fee arrangements that are (i) fair to PSERS and the manager, (ii) are simple to understand and monitor, (iii) result in the best alignment of interests between PSERS and the manager, (iv) are consistent with what PSERS peers are able to achieve, and (v) most importantly have the highest chance of generating the highest risk-adjusted, net-of-fees returns to PSERS over time.</p> <p>Implementation Plan: PSERS will establish a written investment fee policy to formalize its current process.</p>
2. Take an aggressive position when negotiating fee structures with investment managers to obtain the lowest fees possible.	<p>PSERS believes that the key policy objective for any fee structure is that it aid in generating the highest risk-adjusted, net-of-fees returns to PSERS over time, versus other alternatives. PSERS takes an aggressive position with its managers in meeting this objective. PSERS does not believe that a narrow focus on obtaining the lowest fees will necessarily meet that objective. Rather, by considering fairness, simplicity, alignment, and peer consistency as well – it increases its chances of meeting this objective.</p> <p>Implementation Plan: PSERS will continue to aggressively negotiate fair fee arrangements that appropriately align the interest of PSERS and the manager in generating the highest risk-adjusted, net-of-fees returns for PSERS over time, versus other alternatives.</p>

<p>3. Document all fee structure discussions and negotiations between PSERS and the investment manager, including why the fee structure was determined to be reasonable and a justification if the initial fee schedule was unable to be altered/lowered.</p>	<p>PSERS will endeavor to document all fee discussions and negotiations. Currently, the outcome of fee negotiations is documented in both presentations to the Board as well as the contractual agreements with the investment managers. Through the Fee Committee, Allocation Implementation Committee, and its document storage system, Tamale, PSERS has put in place additional procedures to document discussions and negotiations between PSERS and its external managers.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>4. Strengthen written monitoring procedures for the processes used to monitor both quantitative and qualitative measures for both traditional and non-traditional investments, including specific aspects to review, a list of the individuals responsible for reviewing, how monitoring results are to be reported to management, and how to address issues that may affect manager retention.</p>	<p>Please see response to Finding 3.3 above.</p> <p>Implementation Plan: PSERS Management will implement.</p>

Issue Area 4 – Despite having an adequate governance structure with clearly outlined responsibilities, PSERS lacked adequate policies and procedures related to Board trustee adherence to ethics standards and attendance at meetings.

Findings for Issue Area 4

DAG Findings

PSERS Management Response:

Finding 4.1 – PSERS Board size and composition appear to be appropriate and in compliance with the PSERC, but inconsistent trustee attendance threatens consistent and reliable decision-making.

Agreed, in part. PSERS agrees that consistent attendance by our trustees strengthens the decision-making process. The PSERC provides for the use of designees for certain Trustees whose duties as elected or public officials makes it impractical to expect regular “in-person” attendance. Designees are experienced staff members of the Trustee and are afforded access to all information, orientation, training, and supplemental education opportunities as all other Trustees. When factoring in the attendance of both the trustee and his authorized designee, the attendance for those trustees reflected in the table on page 42 of the report increases considerably and, in fact, reaches 100% for four of the seven members. (Republican Representative, Democratic Representative, State Treasurer, and Executive Director of PSBA). Overall, the board members and their designees attended 91.5% of the board meetings for the period July 1, 2013 – November 30, 2016. The table presented in the Draft Audit Report (Pg. 42) only represents the attendance by the ex-officio and legislative members. There are eight (8) other members on the PSERS Board (who may not utilize designees) and a summary of their attendance at meetings for the review period is outstanding, as shown in table below:

Board Position	Meetings Attended	Percent of Meetings Attended
Governor Appointee A	19	86.3%
Governor Appointee B	17	77.3%
Annuitant of the System	22	100%
Active Certified Member A	20	90.9%
Active Certified Member B	21	95.5%
Active Certified Member C	19	86.4%
Active Non-Certified	20	90.9%
School Board	22	100%

Finding 4.2 – PSERS Board’s Code of Ethics and related procedures need strengthened.

Agreed. PSERS already has a strong Code of Ethics, but will offer regular ethics training to the trustees along with obtaining signed ethics acknowledgment statements annually from all trustees and their designees. We will also review and strengthen our process for identifying potential conflict of interest.

Finding 4.3 – PSERS Board completed it duties related to investment operations as outlined in the PSERC and Board’s Investment Policy.

Agreed. PSERS appreciates the acknowledgement that the PSERS Board has performed its investment-related duties and responsibilities as required by the PSERC and the Board’s Investment Policy.

Finding 4.4 – PSERS Board lacks a comprehensive governance manual to unify its numerous policies and guidelines.

Agreed. Although, PSERS already has individual governance-related policies and makes them easily accessible, PSERS Management recognizes having a single governance manual that will be the primary source for PSERS’ governance documents is a best practice.

Recommendations for Issue Area 4	
Recommendations to General Assembly:	PSERS Management Response:
1. Require regular attendance by the board members or their designee(s).	This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
2. Authorize the Board, in consultation with the Executive Director, to remove a board member (excluding ex-officio members, but not their designee) or designee from the board for failure to regularly attend board meetings.	This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
3. Authorize PSERS to develop an attendance policy for all board members and/or designees.	This recommendation is directed to the General Assembly and no response is required from PSERS. Implementation Plan: N/A
Recommendations to PSERS:	PSERS Management Response:
4. Establish and implement a specific and detailed attendance policy for Board members and designees.	PSERS Management will endeavor to implement an attendance policy, but will research our authority to impose consequences if the members and/or designees do not abide by the policy. Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.
5. Implement controls for ensuring that all new Board members/designees sign the ethics policy acknowledgement statement upon being appointed to the Board.	PSERS has already implemented this practice. Implementation Plan: Resolved.
6. Establish and implement provisions within the Board's Ethics Policy to: a. Put in place a minimum amount of ethics training each Board member/designee must receive, with emphasis placed on identifying and disclosing in writing any conflicts of interest, and ensuring that it is obtained. b. Require each Board member/designee to sign the ethics policy acknowledgement statement annually and when the policy substantially changes	a. PSERS will endeavor to implement a minimum amount of annual ethics training for each member and trustee, but will research our authority to impose consequences if the members and/or designees do not abide by the requirement. Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action. b. Although PSERS current practice is to require each Trustee and their Designees to sign an Ethics Policy Acknowledgement upon their initial appointment to the Board, and whenever the Ethics Policy is revised, we will now require an annual signed acknowledgement. Implementation Plan: PSERS Management will implement best practices.

<p>c. Develop procedures to verify that conflict of interest self-reporting was complete for each Board member/designee.</p> <p>d. Request that the Ethics Commission provide the Board with ethics training on an annual basis and provide guidance on the trustees' use of its sample written memo for disclosing a conflict in compliance with 65 Pa.C.S. § 1103(j).</p>	<p>c. PSERS will explore what the best practices are among other public plans and propose revisions to the policy.</p> <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p> <p>d. PSERS will request the Ethics Commission to provide the Board with ethics training annually.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>7. Obtain the Statement of Financial Interest and campaign contribution reports for each trustee, as applicable, and have an individual (independent of the Board) compare them to the list of owners/principals of each investment firm prior to presenting the firm to the Board for vote.</p>	<p>PSERS will explore what the best practices are among other public plans and propose revisions to the policy.</p> <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p>
<p>8. Aggregate the Board's policies and guidelines into a single, comprehensive governance manual.</p>	<p>PSERS will combine the Board's policies and guidelines into a single governance manual.</p> <p>Implementation Plan: PSERS Management will implement.</p>

Issue Area 5 – PSERS’ procedures to ensure it is meeting its diversified investment strategy appear adequate.

Findings for Issue Area 5

DAG Findings	PSERS Management Response:
Finding 5.1 – PSERS adequately reviewed its asset allocation strategy on a regular basis and its verified actual asset values remained within the established target range.	Agreed. PSERS Investment Office Staff and general investment consultant will continue to annually present the asset allocation recommendations to the Board as well as discuss the rationale for any recommended allocation changes.
Finding 5.2 – PSERS’ efforts to develop a diversified asset allocation that minimizes market risk appear to be adequate.	Agreed. PSERS appreciates the acknowledgement that our effort to develop a diversified asset allocation that minimizes market risk appears adequate.
Finding 5.3 – PSERS’ efforts to invest in multiple funds within each asset class to develop a diversified portfolio appear to be adequate.	Agreed. PSERS appreciates the acknowledgement the diversity of our investment portfolio appears to be determined by an investment strategy which is prudent to minimize risk based on market conditions.

Recommendations for Issue Area 5

Recommendations to PSERS Board of Trustees:	PSERS Management Response:
1. Ensures it has sufficient information and adequate discussions to fully understand the complexities and importance of its asset allocation strategy in order to fulfill its fiduciary duty to prudently invest funds.	In September 2016, the entire Board Meeting was devoted to a deep dive into the asset allocation strategy. PSERS Investment Office Staff and general investment consultant will continue to annually present the asset allocation recommendations to the Board as well as discuss the rationale for any recommended allocation changes. Implementation Plan: Current practice. No change required.
2. Continues to analyze its investment strategies and target asset allocation on a regular basis to ensure the Board makes prudent investment decisions, including active and passive investing, as conditions change.	PSERS Investment Office Staff and general investment consultant will continue to monitor the current investment strategies, evaluate new ones, monitor the invested asset allocation relative to the strategic asset allocation plan approved by the Board, and monitor performance of active managers’ net-of-fee, risk-adjusted performance versus applicable passive benchmarks. The results of these activities will continue to be communicated to the Board on a regular basis to allow the Board to fulfill its fiduciary oversight responsibilities. Implementation Plan: Current practice. No change required.

Issue Area 6 – PSERS generally complied with the Public Employee Pension Forfeiture Act, but significant legislative changes and procedural improvements are needed.

Findings for Issue Area 6

DAG Findings	PSERS Management Response:
Finding 6.1 – Overly restrictive language in the Public Employee Forfeiture Act limits pension forfeitures to school employees against students.	This finding is directed to the General Assembly and no response is required from PSERS. PSERS is not able to amend this Act; rather, amendments can only be made by the General Assembly.
Finding 6.2 – PSERS’ pension forfeiture case discovery process needs to be strengthened.	Agreed, in part. The audit revealed that PSERS, in fact, discovered every potential forfeiture case and properly determined which members should forfeit their pensions. PSERS agrees, however, that the discovery process can be strengthened and improved to lessen the administrative burden on staff.
Finding 6.3 – PSERS properly determined which convicted members should forfeit their pensions, but failed to seek recoupment of pension payments made after conviction.	Agreed, in part. PSERS would seek recoupment if amount owed exceeds cost to collect. PSERS did not seek recoupment of pension payments, because it is typically a relatively modest amount of funds. Also, most convicted members do not have the funds to return, and the administrative/legal expenses involved to get the funds back can be costly and outweigh the benefit.

Recommendations for Issue Area 6

Recommendations to General Assembly:	PSERS Management Response:
<p>1. Broaden the language limiting application of the Act 140 sex crimes committed by a “school employee” against a “student” in the “public school” within the course of his/her employment; thus, expanding the application of sex crimes committed by any PSERS member against any individual who is present in a public school or involved in school-related business.</p> <p>Our suggested change to Section 1312 of the Act pertaining to PSERS includes the following:</p> <p>“Crimes related to public office or public employment.’...Any of the criminal offenses set forth in Subchapter B of Chapter 31 (relating to definition of offenses) [of the Crimes Code] when the criminal offense is committed by a school employee as defined in 24 Pa.C.S. § 8102 (relating to definitions) against any individual present in a public school or involved in school-related business student. .”</p>	<p>This recommendation is directed to the General Assembly and no response is required from PSERS. PSERS is not able to amend this Act; rather, amendments can only be made by the General Assembly.</p> <p>Implementation Plan: N/A</p>

<p>2. Broaden the definition of “school employee” in the Code to include provision for anyone receiving pension benefits who performs any services directly benefiting a public school, as well as any independent contractor or a person receiving pension benefits who is compensated on a fee basis.</p> <p>Our suggested change to Section 8102 of the Code includes the following: “School employee.’ Any person engaged in work relating to a public school for any governmental entity for which work he is receiving regular remuneration as an officer, administrator or employee or any person receiving pension benefits who performs any services directly benefiting a public school including excluding, however, any independent contractor or a person compensated on a fee basis.”</p>	<p>This recommendation is directed to the General Assembly and no response is required from PSERS. PSERS is not able to amend this Act; rather, amendments can only be made by the General Assembly.</p> <p>Implementation Plan: N/A</p>
<p>Recommendations to PSERS:</p>	<p>PSERS Management Response:</p>
<p>3. Require employers to formally report employees charged with criminal offenses applicable to Act 140 to them by promulgating regulations through the regulatory review process and to issue a related administrative directive to all “public schools” as defined in the PSERC.</p>	<p>PSERS educates and notifies school employers of the need to notify PSERS when an employee is charged with a forfeitable offense. Promulgating a regulation requiring all school employers to report employees charged with a forfeitable offense would have no practical effect unless PSERS had the authority to enforce the failure to report such a charge and issue consequences on the employer. PSERS does not have the authority to issue such a regulation or impose consequences of a violation. PSERS also does not have the authority to issue a management or administrative directive. 4 Pa. Code § 1.2.</p> <p>Implementation Plan: N/A</p>
<p>4. Continue to pursue a subscription to JNET and use its resources to identify pension forfeiture cases.</p>	<p>PSERS finalized its arrangement with JNET and AOPC to receive all information pertaining to enumerated crimes under the Act in April 2017, and is working to implement the system.</p> <p>Implementation Plan: PSERS Management is in the process of implementing this recommendation.</p>
<p>5. Strengthen its written procedures for pension forfeitures to include the documents required to be maintained in the member’s case file, the use of the tracking spreadsheets to evidence oversight of the pension forfeiture cases, and a detailed</p>	<p>PSERS has amended its spreadsheet to include a notation evidencing PSERS evaluation of the PDE’s list of disciplinary action taken against PSERS members. PSERS does not maintain information on non-PSERS members or crimes not subject to the Act.</p> <p>PSERS will review its existing record retention policy as it relates to maintaining evidence of the review in the member’s case file.</p>

<p>description of the evaluation of the PDE's list of disciplinary actions taken against Pennsylvania certified educators.</p>	<p>Implementation Plan: PSERS has implemented these changes and will implement the remaining changes.</p>
<p>6. Pursuant to the written procedures developed in the above recommendation, document the evaluation of PDE's list of disciplinary actions taken against Pennsylvania certified educators and the supervisory review of the evaluation. The documentation should include, but not be limited to, the dates the evaluation and review of the evaluation were performed, the initials of the individual performing the evaluation, the initials of the individual reviewing the evaluation, and a comment for each case stating whether the case was included in PSERS' tracking list or the reason why the case is not subject to pension forfeiture.</p>	<p>PSERS has amended its spreadsheet to include a notation evidencing PSERS evaluation of the PDE's list of disciplinary action taken against PSERS members. PSERS does not maintain information on non-PSERS members or crimes not subject to the Act.</p> <p>Implementation Plan: PSERS has implemented these changes and will implement the remaining changes.</p> <p>PSERS will review its existing record retention policy as it relates to maintaining evidence of the review in the member's case file.</p> <p>PSERS has determined that the level of supervisory review is appropriate under the current circumstances.</p> <p>Implementation Plan: No further action required.</p>
<p>7. Develop written policies and procedures to seek recoupment of overpayments of annuity benefits paid after the date of conviction.</p>	<p>PSERS will work to develop a recoupment policy.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>8. Incorporate a request for repayment of the annuity benefits paid after the date of conviction within the pension forfeiture letter sent to the member.</p>	<p>PSERS will incorporate a request for repayment of the annuity benefits paid after the date of conviction within the pension forfeiture letter.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>9. Consult with the Office of Attorney General to determine if utilizing its resources to attempt to recapture annuity benefits paid after the date of conviction exceeding a minimum threshold would be feasible and cost effective.</p>	<p>PSERS will work to develop a recoupment policy and will determine whether and what extent to utilize the Office of the Attorney General.</p> <p>Implementation Plan: PSERS Management will implement.</p>

Prior Finding 1.3 – PSERS’ Internal Audit Office lacked the organizational independence and staff resources necessary to effectively complete audits. (Partially Resolved)

Findings for Prior Finding 1.3

DAG Findings	PSERS Management Response:
<p>Prior Finding 1.3 – PSERS Internal Audit Office lacked the organizational independence and staff resources necessary to effectively complete audits. (Partially Resolved)</p>	<p>PSERS Management agrees that we need to add additional safeguards to ensure the independence of the Internal Audit Office. We are in the process of restructuring the Audit/Budget Committee so that is a stand-alone Audit Committee or Audit & Compliance Committee. We plan to develop comprehensive charters for the Audit Committee and the Internal Audit Office that outline purpose, authority and responsibilities of each entity. The Internal Audit Office will also present a risk assessment and audit plan to the Audit Committee on an annual basis. We will also provide quarterly updates to the Audit Committee on the audit status, audit results and other compliance activities.</p>

Recommendations for Prior Finding 1.3

Recommendations to PSERS:	PSERS Management Response:
<p>1. Change the organizational structure of the internal audit function to promote independence and comply with the Institute of Internal Auditors standards.</p>	<p>PSERS agrees to implement best practice.</p> <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p>
<p>2. Develop an Internal Auditor Office Charter, defining its purpose, authority, and responsibilities, and have it approved by the Board. The charter should include:</p> <ul style="list-style-type: none"> a. Defining the nature of the Internal Auditor Office’s relationship to the Audit/Budget Committee, Board, and Executive Director. b. Maintaining the office’s independence and objectivity, including prohibiting the reassignment of internal audit office staff to duties that compromise its ability to maintain independence. c. Conducting risk assessments of PSERS’ internal controls by the office on a recurring basis. d. Establishing an annual audit plan by the office to be reviewed and approved by the Audit/Budget Committee. 	<p>PSERS will endeavor to implement an Internal Auditor Office Charter which addresses the listed elements.</p> <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p>

<p>3. Revise the Audit/Budget Committee responsibilities in the Bylaws to include:</p> <ul style="list-style-type: none"> a. Ensuring the independence of the committee's internal audit process. b. Ensuring there are no unjustified restrictions or limitations placed on internal audit staff by the committee. c. Reviewing and approving the committee's annual audit plans. d. Reviewing the effectiveness of the committee's internal audit function, including its compliance with IIA Standards. 	<p>PSERS will develop and present By-law amendments which address the listed elements.</p> <p>Implementation Plan: PSERS Management will provide information and a recommendation to the PSERS Board for consideration and possible action.</p>
<p>4. Reevaluate the current duties and responsibilities assigned to the Internal Auditor Office and consider either removing the compliance duties or requesting additional internal audit staff and establishing two distinct areas (a compliance section and internal audit section) with specifically assigned staff to ensure the internal audit function remains independent and produces timely audits.</p>	<p>PSERS will consult with peer pension funds and/or have a study performed to determine the structure and optimal number of staff for the Internal Audit Office.</p> <p>Implementation Plan: PSERS Management will implement.</p>
<p>Recommendation to Governor's Office of Administration:</p>	<p>PSERS Management Response:</p>
<p>5. If requested by PSERS, evaluate the need for a complement increase for the PSERS Internal Auditor Office.</p>	<p>This recommendation is directed to the Office of Administration and no response is required from PSERS.</p> <p>Implementation Plan: N/A</p>