Special Review

Board of Trustees of the Maryland Teachers and State Employees Supplemental Retirement Plans Investment Contract Pool

Unrealized Losses Were Not Adequately Disclosed to Participants

MSRP Oversight of the Investment Contract Pool Needs Improvement

October 2009

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

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October 9, 2009

Delegate Steven J. DeBoy, Sr. Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We conducted a review of an allegation received through our fraud, waste, and abuse hotline regarding the possible lack of disclosure of losses incurred in the Maryland Investment Contract Pool (ICP), which is one of several investment options of the Maryland Supplemental Retirement Plan (MSRP). The reported book value of the ICP portfolio was approximately $729 million as of December 31, 2008.

According to the MSRP, the ICP seeks to preserve principal and to provide a relatively stable rate of return. The ICP's portfolio includes stable value contracts and a variety of fixed income instruments. The ICP's rate of return is generally determined by the performance of its investments.

Our review found that MSRP did not adequately disclose unrealized ICP investment losses in financial publications made available to existing or prospective plan participants, nor were the unrealized losses disclosed in MSRP's 2007 audited financial statements. As of December 31, 2008, these unrealized losses totaled approximately $48 million. In addition, MSRP did not independently verify the reported market value of ICP investments, and did not independently verify the accuracy of the interest rates calculated by the investment manager that were used to credit earnings to participant accounts.

Our review also disclosed that MSRP and the Board need to improve their documentation of the monitoring and management of the ICP. From the onset of our review, MSRP management personnel were consistently unable to satisfactorily address fundamental questions, including a clear and accurate explanation of the wrapper agreements, which are secured to provide protection of portfolio principal under certain circumstances, and could not provide us with relevant documents relating to the ICP. We were advised by MSRP management personnel that MSRP did not have such information because such information and documents were the responsibility of the investment manager. However, in our opinion, MSRP and the MSRP Board have a fiduciary responsibility to actively oversee management of the ICP, including the performance of contractors. For example, although certain sub-managers did not meet established performance standards for close to a two-year period, there was a lack of documentation to indicate that MSRP or the MSRP Board had taken any measures to address this substandard performance.

Subsequent to the completion of our fieldwork on the special review and issuance of our preliminary findings, the MSRP Board engaged a consultant to address a number of questions and issues raised during the course of our review. The consultant issued its report on July 7, 2009. MSRP provided us with a copy of the report and we discussed the consultant's findings and conclusions with MSRP representatives. As deemed appropriate, we considered the consultant's findings in this report.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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Executive Summary

- **The Maryland Supplemental Retirement Plan (MSRP) did not adequately disclose unrealized losses of the Maryland Investment Contract Pool (ICP) investments in financial reports made available to existing and prospective plan participants, nor were the unrealized losses disclosed in MSRP's 2007 audited financial statements. Additionally, MSRP did not confirm the existence of ICP investments with the custodian bank. As of December 31, 2008, unrealized ICP losses totaled approximately $48 million.**

  MSRP should clearly disclose the actual dollar amount of ICP unrealized gains or losses to existing and prospective plan participants, and disclose the fair value of ICP investments in its financial statements. MSRP should also ensure that the existence of ICP investments is periodically confirmed with the custodian bank.

- **Documentation was not available to substantiate that the market value of ICP investments reported to the MSRP Board by the investment manager had been independently verified. Additionally, MSRP did not independently verify the accuracy of the interest rate calculated by the investment manager that was used to credit earnings to participant accounts.**

  MSRP should obtain periodic independent verifications of the market values of ICP investments. MSRP should also verify the accuracy of the interest rate calculated by the investment manager.

- **Wrapper (insurance) agreements executed with financial institutions to cover ICP investment losses were highly complex and ambiguous, and MSRP personnel and the investment manager were unable to clearly explain how the agreements preserve the investment portfolio. Furthermore, certain agreements were apparently not signed until after we requested them during this review.**

  MSRP should, in conjunction with the Office of the Attorney General, obtain clarification as to how the agreements protect the investment portfolio, including the circumstances under which payments are made and the timing of such payments. MSRP should also maintain current signed wrapper agreements.

- **MSRP management and the MSRP Board did not adequately document their monitoring of the investment manager and the sub-managers, and were unable to answer fundamental questions or provide us with vital documents relating to the ICP.**

  MSRP and the Board should establish procedures to adequately document their monitoring of the performance of the investment manager and sub-managers.

Scope, Objective, and Methodology

We conducted a review of an allegation received through our fraud, waste, and abuse hotline related to the Maryland Teachers and State Employees Supplemental Retirement Plans (MSRP). The allegation related to the possible lack of disclosure of losses incurred in the Maryland Investment Contract Pool, an investment option of the MSRP.

The purpose of our review was to determine whether the allegation we received was valid. This review was performed in accordance with State Government Article, Section 2-1220 of the Annotated Code of Maryland.

Our review consisted of tests, analyses, observations, and discussions with MSRP personnel, contractors, and others, as we deemed necessary to achieve our objectives. Our review did not constitute an audit conducted in accordance with generally accepted government auditing standards. Had we conducted an audit in accordance with generally accepted government auditing standards, other matters may have come to our attention that would have been reported. Our review was conducted primarily from November 2008 through February 2009.

Background Information

Agency Responsibilities

Title 35 of the State Personnel and Pensions Article of the Annotated Code of Maryland provides that the Board of Trustees (Board) of the Maryland Teachers and State Employees Supplemental Retirement Plans (MSRP) is responsible for implementing, maintaining, and administering the State's three voluntary tax sheltered income deferral plans for State employees and certain employees of local boards of education and municipalities. These plans are permitted under Sections 401(k), 403(b), and 457 of the Internal Revenue Code. Additionally, Title 32 of the aforementioned Article authorizes employer-matching contributions of up to $600 per participant each year (subject to budget authority) for State Employees' Pension System members who elect to contribute to the supplemental retirement plans. These employer-matching contributions are maintained in a defined contribution-matching plan permitted under Section 401(a) of the Code. The Maryland Investment Contract Pool (ICP), also referred to as the Stable Value Fund, is available as an investment option in the 401(a), 401(k), and 457 Plans. The assets of these plans are held in trust for the plan participants and the related expenses incurred by MSRP (such as administration costs) for these plans are paid from the contributions to, or from the income or assets of, the plans.[1]

MSRP entered into a contractual agreement with an entity to provide investment management services (investment manager) for ICP funds invested by plan participants. These services include, in part, preparing a written investment policy (with Board approval), selecting investment sub-managers to make investments on behalf of participants, subsequently monitoring the investment performance of the sub-managers, and providing the Board with a quarterly performance review report of the ICP. At December 31, 2008, there were four sub-managers responsible for investing ICP funds. Additionally, MSRP entered into a contractual agreement with a consulting company to provide investment advisory services. These services include evaluating the performance of the investment manager, providing MSRP with additional investment options for plan participants, and generally assisting MSRP in achieving its objectives. Finally, MSRP has contracted with an independent certified public accounting firm to perform annual audits of the Plan's financial statements, including ICP investments.

[1] A third-party administrator maintains participant investment records and handles participant transactions.

MSRP comprises 15 employees, including an executive director who reports to a nine-member Board appointed by the Governor. The Board has approved investment guidelines and policies governing the ICP. The Board has also established an Investment Committee, comprised of several Board members, that makes recommendations to the Board on investment matters (such as changes in investment options offered to participants). The Board is responsible for approving all investment options made available to participants in the supplemental retirement plans.

Maryland Investment Contract Pool Overview

According to the *ICP Fact Sheet* (a quarterly report published on the MSRP website), "the ICP invests in a diversified portfolio of stable value contracts issued by banks, insurance companies, and other financial institutions, and a variety of fixed income instruments including U.S. Government and agency securities, mortgage-backed securities, asset-backed securities, and corporate bonds. Investors [participants] earn the average return received under all contracts in effect at any point in time. The ICP's return is affected by the general level of interest rates as well as by cash flows, including those from employer and employee contributions, withdrawals, and transfers into and out of the ICP."

MSRP's ICP Investment Policy and Guidelines provide that the objective of the ICP is to preserve principal and provide a stable, competitive return for participants. The *Guidelines* further indicate that the ICP emphasizes safety through the preservation of principal, and invests primarily in guaranteed investment contracts (GICs) that may be covered by a principal guarantee. The investment manager is responsible for calculating the amount of interest (referred to as the crediting rate) that is to be periodically credited to individual ICP participant accounts. Prior to the initiation of our review, the investment manager prepared this calculation quarterly. However, since January 2009, the rate has been calculated monthly.

Furthermore, the investment manager's response to the original request for proposal made clear its understanding regarding the main objective of the ICP. Specifically, in its technical proposal, dated February 22, 2006, the investment manager stated the following:

> "Stable Value (ICP) is the participant's conservative investment option. For this reason, the investment manager must employ an approach that emphasizes care, diligence, and safety of principal. …[The investment manager] recognizes that Stable Value is perceived by participants as the investment equivalent of a

> retirement ‘security blanket’. Participants count on the stable value portfolio to deliver safety of principal.…We have structured an investment process and risk management approach that places paramount importance on endeavoring to deliver safety of principal.”

While the aforementioned ICP related documents indicate that the objective of the ICP is to preserve principal, MSRP’s *ICP Fact Sheet* contains certain disclaimers regarding principal in a paragraph that discusses risk. In this regard, the *Fact Sheet* states that ICP investments have risks, and there is a possibility that the ICP may not achieve its investment objectives and may not maintain its principal value. The *Fact Sheet* further states that, to minimize this risk, the ICP’s investment managers regularly monitor credit ratings and the financial strength of the issuers of contracts (wrapper agreements) and fixed income securities. These wrapper agreements, with various financial services companies, are intended to preserve the ICP investment portfolio.

MSRP’s investment manager reported that the book value of ICP investments totaled approximately $729 million for 27,163 employees in the ICP as of December 31, 2008, making the ICP the single most popular investment option offered by MSRP based on amounts invested. In total, approximately $1.9 billion was invested in the supplemental retirement plans offered by the State as of December 31, 2008.

Findings and Recommendations

Investment Contract Pool Performance and Evaluation

Finding 1
MSRP did not adequately disclose unrealized losses of ICP principal to existing and prospective plan participants even though this information was provided monthly to MSRP and the Board. As of December 2008, the unrealized losses totaled approximately $48 million.

Analysis
MSRP did not adequately disclose to existing and prospective plan participants unrealized losses of ICP principal, which totaled approximately $48 million as of December 2008. In our opinion, this inadequate disclosure limited the ability of ICP participants to make informed investment decisions. Generally, an unrealized loss occurs when the current market value of an investment is less than the price paid to purchase the investment (book value). MSRP's investment manager disclosed the book value and market value of the ICP to the Board each month. However, MSRP did not adequately disclose the unrealized losses in any financial reports made available to plan participants. This is especially significant to participants since a main objective of the ICP is to emphasize safety through preservation of principal, and the ICP is the most conservative investment option offered to participants in three of the four MSRP plans.[2] Table 1, which follows, depicts the unrealized gain and losses of the ICP for calendar year 2008, as reported to the Board:

[2] The 403(b) Plan includes a money market fund option, but participation in that plan is limited to educational affiliated employees (such as, educational institution employees).

Table 1 Unrealized Gain and Losses of ICP Principal Value			
Month	**Book Value**	**Reported Market Value at Month End**	**Cumulative Unrealized Gain/(Loss)**
January	$639,061,655	$641,589,527	$ 2,527,872
February	644,064,391	642,685,989	(1,378,402)
March	653,411,277	646,281,492	(7,129,785)
April	659,090,084	648,583,426	(10,506,658)
May	662,157,290	646,259,346	(15,897,944)
June	666,658,930	648,791,407	(17,867,523)
July	678,531,307	654,670,011	(23,861,296)
August	681,515,968	658,341,818	(23,174,150)
September	690,665,619	654,619,601	(36,046,018)
October	716,566,149	659,349,491	(57,216,658)
November	723,752,226	667,476,167	(56,276,059)
December	729,099,986	681,131,508	(47,968,478)

Source: Monthly and Quarterly Market-to-Book Reports to the Board
Note: The unrealized gain and losses are cumulative. At the time of our review, there was no documentation on file to support that the market values reported to the Board were independently verified (Finding 3).

Prior to September 2008, MSRP did not disclose unrealized losses in the ICP to plan participants. However, MSRP believes that the unrealized losses are now adequately disclosed via the quarterly *ICP Fact Sheet*, which is publicly available. Subsequent to the initiation of our review, MSRP decided, in November 2008, that it would begin issuing a disclosure related to unrealized ICP principal losses beginning with the September 2008 *Fact Sheet* (which, at that time, had yet to be made available to the public). Specifically, this and all subsequent *Fact Sheets* contain a line item in the "Sector Allocation" section that is identified as "Wrapper Exposure" with a corresponding percentage. A footnote to this line item states the following:

> "Wrapper exposure represents the difference between the book value of the wrapper contracts [agreements] and the market value of the underlying fixed income securities as a percentage of the entire Fund. A positive wrapper exposure denotes that the Fund's book value exceeds the market value of the underlying assets and the issuer of the wrapper contract has a potential liability to the Fund. A negative wrapper exposure means that the market value of the underlying assets exceeds the book value of the wrapper and the Fund may have a potential liability to the contract issuer."

In our opinion, the term “wrapper exposure” is not adequately descriptive of the condition, and the related explanation is unwieldy and does not serve to readily inform the average participant as to the specific unrealized loss amount and the implications on plan participants. In order for an ICP participant to determine the unrealized loss in the ICP, the participant would first have to read and comprehend the footnote, and then calculate the loss by multiplying the “wrapper exposure” percentage by the total book value of the ICP assets. The specific unrealized loss or gain dollar amount is not reported by MSRP on the *ICP Fact Sheet* (see Exhibit 1 for the September 2008 *ICP Fact Sheet*). We were advised by the MSRP Board that it believed that disclosure of the specific dollar amount of unrealized ICP losses would be confusing to plan participants.

In our opinion, since the extent of unrealized losses was not adequately or clearly disclosed, the ability of existing and prospective plan participants to make informed investment decisions using basic and critical financial information was significantly impaired.

Recommendation 1
To foster transparency, we recommend that MSRP specifically disclose the actual dollar amount of ICP unrealized losses or gains to existing and prospective plan participants on an ongoing basis, and provide a plain language description of the wrapper exposure.

Finding 2
ICP unrealized losses were not disclosed in MSRP’s 2007 audited financial statements.

Analysis
MSRP only reported the cost (book value) of the ICP investments in the December 31, 2007 audited financial statements, and did not disclose the ICP’s unrealized losses, which totaled approximately $5 million at that date. The applicable accounting principles require disclosure of both the investments’ cost and fair value (market-based measurement). However, only the cost was reported in the 2007 financial statements. Without a related disclosure of the fair value, users of the financial statements would be unaware of the $5 million unrealized loss. As of May 20, 2009, the December 31, 2008 audited financial statements had not been completed and, as such, were not subject to our review.

We were advised by senior MSRP management personnel that MSRP had reported its ICP investments at cost in the body of the financial statements based on the recommendations of MSRP’s independent accounting firm. However, our review of the minutes of the July 24, 2007 MSRP Board meeting disclosed that, in fact, the accounting firm advised MSRP that the investments should be reported at fair value, in accordance with the related accounting principles. At that time, the firm acknowledged that MSRP's practice was to report these investments at cost, not fair value, and acquiesced to MSRP's reporting preference, as the firm concluded that the $5 million difference between cost and fair value was not significant to the financial statements taken as a whole.

Additionally, our review of the independent accounting firm's working papers disclosed that the firm did not confirm the existence of reported ICP investments with the custodian bank. Rather, the firm confirmed the investments with the investment manager. Furthermore, MSRP did not have an internal control procedure to verify the existence of reported assets. Periodic confirmation of investments with the custodian bank is critical to obtaining independent assurance as to the existence of all reported ICP assets.

Recommendation 2
We recommend that MSRP

a. **disclose the fair value of the ICP investments in its annual audited financial statements, as required by applicable accounting principles; and**
b. **ensure that the existence of ICP investments is periodically confirmed with the custodian bank.**

Finding 3
MSRP lacked documentation to substantiate that the market value of ICP investments, reported by the sub-managers to the investment manager (and forwarded to the MSRP Board), had been independently verified.

Analysis
MSRP lacked documentation to substantiate the independent verification of the market value of ICP investments reported by the sub-managers to the investment manager and forwarded to the MSRP Board. As of September 2008, the market value of ICP investments reported to the Board totaled approximately $654.6 million. It is important to note that the market value information is used to calculate the crediting interest rate and, in part, to evaluate the investment performance of the sub-managers.

Specifically, each sub-manager reported the market value of its ICP investments to the investment manager, which then reported the market value of ICP investments to the Board in its monthly performance review reports. Consequently, there was no documentation to substantiate that the reported market values were independently verified by any party. Furthermore, neither the MSRP nor the investment manager knew if the related mortgages that underlie some of these investments were supported by notes that were legally assigned and recorded. In this regard, there have been several recently reported judicial rulings nationwide that prevented lending institutions from foreclosing on mortgage-related investments of this nature because a legally assigned and recorded note could not be provided.

Although we were advised by the investment manager that the market valuations reported by the sub-managers were assigned according to the respective sub-manager's internal procedures, which may have included valuations performed by an independent pricing service, the investment manager could not provide us the specifics of these pricing procedures nor any documentation supporting this representation. Furthermore, the investment manager and one sub-manager specifically disclaimed any liability relating to the accuracy of the reported market values of ICP investments. In its investment report to the Board, the investment manager also provided a disclaimer related to the market value reports provided by sub-managers, stating that the information received from each sub-manager

> "…cannot be independently verified [by the investment manager]. [The investment manager] has not made any specific inquiry as to the accuracy of the information by the [sub-manager]."

In addition, we noted that market value reports submitted by one sub-manager included its' own disclaimer:

> "The valuations provided herein are for informational purposes and represent our estimate of the current market value of an instrument. The valuations are not an audited financial statement, but are supplied in good faith based on information we believe to be accurate."

Because of the lack of an independent verification of the reported market values of ICP investments, the values could be misstated. We advised the Board of our concerns regarding the reported market valuations of ICP investments. In response to our concerns, the Board discussed this issue with the investment manager during the February 23, 2009 Board meeting, at which time the investment manager stated that there could be a potential conflict of interest if it performed the market value verifications. In its May 2006 technical proposal to MSRP, provided in conjunction with its bid submission to be selected as the ICP investment manager, the current investment manager had recommended the hiring of a third party to independently calculate and track the market value of the ICP portfolio. However, there was no documentation on file to substantiate that MSRP or the investment manager had attempted to hire a custodian to provide independent investment valuations of the ICP portfolio.

Recommendation 3
We recommend that MSRP obtain, on a periodic basis (at least quarterly), independent verifications of the market values of investments held by the ICP.

Finding 4
MSRP did not independently verify the accuracy of the interest rates used to credit earnings to participant accounts, even though the investment manager issued a written disclaimer as to the accuracy of the interest rate calculations that it was responsible for preparing.

Analysis
MSRP did not adequately monitor the interest rates used to credit earnings to participant accounts. As previously noted, the investment manager calculates an interest rate (referred to as the "crediting rate") and the corresponding amount of interest that is credited monthly to individual ICP participant accounts. In effect, the crediting rate is to approximate the rate of return earned on the investments that comprise the ICP portfolio as of a specific point in time. We noted the following regarding the calculation of the crediting rate:

- MSRP did not independently verify the accuracy of the interest rates that were calculated by the investment manager and used to credit participant accounts. Furthermore, the investment manager issued a written disclaimer with regard to each sub-manager as to the accuracy of its calculated crediting rates:

> "The information…obtained by [the investment manager] from the [sub-manager]…is needed to allow [the investment manager] to calculate the crediting rates and administer the provisions of the stable value fund wrapper contracts. [The investment manager] is dependent upon the…information and the information cannot be independently verified by [the investment manager]. [The investment manager] has not made any specific inquiry as to the accuracy of the information by the [sub-manager]. [The investment manager] shall not be responsible for liabilities resulting from errors in the calculation of the crediting rates or other provisions of the wrapper contract that are caused by errors in the information provided by the [sub-managers]. … [The investment manager] does not provide any guarantee, warranty, or representation that the amount of interest credited to participants in any calendar quarter…will equal the actual return earned by the ICP fund during that quarter, or period of time…[The investment manager] is not guaranteeing the … Crediting Rate of the ICP…."

Investment gains and losses in the ICP portfolio are a critical component of the crediting rate calculation prepared by the investment manager. However, sub-managers did not report to the investment manager the actual details of investment gains and losses that were incurred. Without the aforementioned detail on investment gains and losses from the sub-managers, the accuracy and appropriateness of the interest rate calculated by the investment manager and used to credit earnings to participants cannot be assured.

- MSRP policy, through November 2008, was to establish the crediting rate paid to investors quarterly in advance. Consequently, there may not necessarily be a correlation between the quarterly crediting rate and the underlying portfolio performance. We questioned MSRP management as to how they could pay ICP participants a relatively high rate of interest while the ICP portfolio was experiencing unrealized losses. For example, for the quarter ending September 2008, the rate paid to participants was 4.39 percent yet, as of September 30, 2008, the ICP had incurred a cumulative unrealized loss of $36 million. Furthermore, for the quarter ending December 2008, the rate paid to participants was 4.40 percent while the ICP had incurred a cumulative unrealized loss of approximately $48 million, as December 31, 2008. Effective January 1, 2009, the policy was changed by the MSRP Board to reset the interest rate monthly; the interest rate was reduced to 3.5 percent and has generally continued to decline.

Recommendation 4
We recommend that MSRP

a. **work with the investment manager to eliminate the various disclaimers relating to the accuracy and validity of the crediting rate calculation, to the extent possible; and**
b. **establish a process to verify the accuracy of the crediting rate calculated by the investment manager.**

Finding 5
Wrapper (insurance) agreements executed with financial institutions to cover investment losses appear highly complex and ambiguous, and MSRP was unable to clearly explain how the agreements preserve the investment portfolio. Furthermore, certain of these agreements were apparently not signed until after we requested them.

Analysis
As previously noted, we initiated this review based on an allegation that MRSP was not disclosing potential losses in the ICP to participants. During the early stages or our fieldwork, MSRP officials advised us that insurance had been obtained in the event the

ICP suffered realized losses, so that unrealized ICP principal losses were not an overly significant concern. However, our review of certain wrapper agreements found them to be complex legal documents, with a number of ambiguous terms and conditions, and MRSP was unable to clearly explain how the agreements preserved the investment portfolio.

- Throughout the course of our review, we were unable to obtain clear responses from MSRP management, the MSRP Board, Board legal counsel, and the investment manager describing the circumstances under which MSRP could recover funds from the wrapper providers (financial institutions). After our repeated attempts to verify the existence of and the process for invoking such "insurance," those parties directed us to certain contract provisions in the wrapper agreements. Although these provisions were purported to specify the circumstances and time frames for obtaining payments under the agreements, the provisions did not serve to clarify the matter. For example, one of the provisions indicated that a payment would be required from the provider on the contract termination date for the amount by which the book value of the covered ICP investments exceeded the market value. However, the contract further provided that the termination date had to be agreed to by both the investment manager and the provider. Consequently, it appears the provider could potentially avert payments for investment losses by not agreeing to a termination date. Furthermore, the investment manager advised us that the contracts are "managed so as to make that event [payment by the provider of any investment losses] unlikely to occur." We were further advised by the investment manager that this means the losses would be offset by the continuing reduction of the crediting (interest) rate used to compute earnings for ICP participants, and could result in the payment of no interest to ICP participants for an extended period. In this regard, the provider and the investment manager would make every effort to continually extend the termination date, until such time as the market value equaled the book value.

  The aforementioned comments by the MSRP investment manager could conflict with *MSRP's ICP Investment Policy and Guidelines*, which provide that the desired requirements for the wrapper (insurance) agreements is for such agreements to provide for a book value settlement provision with "a limitation on duration extension." In this regard, the investment manager recognized the importance of this MSRP Guideline and stated, in its technical bid proposal, that it "…has the requisite expertise to evaluate issuers of contracts, to negotiate superior terms, and to structure customized contracts that address the specific needs of our clients."

Since the timing and extent of the actual payout would depend on several factors including the composition of the investment portfolio and the various maturity dates of such investments, there could be delays of several years in recovering investment losses—a length of time that seems contrary to "a limitation on duration extension."

We also noted that the financial status of certain of the providers raises concerns regarding their ability to make payments that may be required under the wrapper agreements. Specifically, two providers have had their credit ratings recently downgraded. As of February 23, 2009, both providers were still above the credit threshold established by MSRP for insurers of investments. However, we were advised by the investment manager that it would be difficult to find a replacement insurer in the current financial environment should any of the providers fall below MSRP's credit threshold. Also, representatives of MSRP management and the investment manager advised us that, under the terms of the agreements, the existing unrealized losses would not be covered if MSRP elected to unilaterally withdraw from them.

- MSRP did not have on file copies of the wrapper agreements executed between the investment manager and the providers (financial institutions). In order to provide us these documents, MSRP had to request them from the investment manager. Furthermore, it appeared that several of the agreements we ultimately received (such as the contracts and confirmation notices) were signed well after the effective dates of the agreements and after we made inquiries to obtain copies of the documents. For example, two wrapper agreements with one provider had effective dates of March 2007 and September 2007; however, the agreements were not signed until December 2008, which was after our request for these documents. Furthermore, it appears as if the same signature page was used for both agreements. We were advised by the investment manager that signatures on the agreements are not necessary for the contracts to be enforceable. Board legal counsel concurred with this position.

According to the investment manager, the reported unrealized losses in the ICP totaled approximately $48 million as of December 31, 2008. During fiscal year 2008, payments made to the wrapper providers totaled approximately $600,000. We were advised by the investment manager that these payments could increase significantly in the near future due to current market conditions.

Recommendation 5
We recommend that MSRP

a. **in conjunction with the Office of the Attorney General, obtain clarification about how the agreements protect the ICP investment portfolio, including the circumstances under which payments are made under the agreements, and the timing of such payments;**
b. **maintain current signed wrapper agreements; and**
c. **monitor the financial status of wrapper providers, and take appropriate measures in the event an insurer falls below MSRP's established credit threshold.**

MSRP Oversight of the Investment Contract Pool

Finding 6
Monitoring of sub-managers performance was not adequately documented.

Analysis
MSRP management, the Board, and the investment manager did not adequately document efforts to monitor the performance of the sub-managers. In this regard, we noted the following conditions:

- Although the performance of certain sub-managers did not meet established standards, and this information was reported to MSRP management, the MSRP Board, and the investment manager, there was no substantive documentation of efforts taken to address the performance of these sub-managers. We noted that the Board did take action in 2008 to remove one poor performing sub-manager; however, no action was taken with respect to two additional sub-managers providing ICP investment services as of December 2008 that had failed to meet investment performance standards over approximately a two-year period. One sub-manager, with approximately $138 million in its ICP investment portfolio as of December 31, 2008, had produced rates of return that were 15.5 percent and 8.7 percent below the performance standards set for it for the one-year and two-year periods ending December 31, 2008, respectively. For example for the one-year period ending December 31, 2008, this sub-manager achieved a negative rate of return of 10.64 percent while the performance standard was 4.86 percent. The MRSP Board advised us that they were aware of these issues but had not adequately documented their discussions regarding these matters. As of December 31, 2008, four sub-managers were actively providing ICP investments services.

- The aforementioned performance standards used by MSRP are based on established indexes. Each index contains investment sector allocations (referred to as benchmarks),[3] and an index is assigned to each sub-manager to serve as an investment guideline. MSRP permitted the sub-managers to deviate from the assigned investment sector allocations as long as the investments complied with *MSRP's ICP Investment Policy and Guidelines*, and the sub-managers' overall performance met or exceeded the performance of the established index. However, we noted that the two aforementioned sub-managers with substandard performance had significantly deviated from the benchmarks of their respective indexes, as noted in Table 2.

Table 2
Comparison of Benchmarks to Actual Sector Investments as of December 2008

	Sub-Manager 1			Sub-Manager 2		
Sector Allocation	Benchmark	Actual	Difference	Benchmark	Actual	Difference
Cash and Short Term Investment Funds (STIF)	0.0%	1.4%	1.4%	0.0%	2.7%	2.7%
Treasury	44.2%	29.6%	-14.6%	20.6%	1.7%	-18.9%
Government-Related	30.2%	11.0%	-19.2%	13.4%	12.6%	-0.8%
Corporate	25.6%	27.6%	2.0%	15.2%	24.5%	9.3%
Securitized:						
Mortgage Backed Securities (MBS)	0.0%	1.2%	1.2%	44.9%	55.7%	10.8%
Asset Backed Securities (ABS)	0.0%	13.9%	13.9%	0.8%	2.7%	1.9%
Commercial Mortgage Backed Securities (CMBS)	0.0%	15.5%	15.5%	5.2%	0.0%	-5.2%

Source: Investment records obtained from the investment manager; however, the totals may not equal 100%.

In this regard, MSRP management advised us that "…we expect the allocations of each sub-manager to differ, sometimes significantly, relative to the allocations.…'Deviations' made by sub-managers from the investment allocation of their assigned benchmarks are not only permitted, they are expected." For example, we noted that, for one sub-manager (Sub-Manager 1 in the Table 2), the index benchmark was zero for securitized investments, but its actual holdings of securitized investments totaled approximately $47 million, which represented 30.6 percent of its ICP portfolio as of December 31, 2008. Another sub-manager's (Sub-manager 2 in Table 2) index benchmark was 20.6 percent for U.S. Treasuries (which

[3] The term "benchmark" should not be construed as a contractual requirement, but rather, as a target goal.

equated to approximately $27 million); however, this sub-manager had only invested 1.7 percent (approximately $2 million) of its investment portfolio in U.S. Treasuries. Had the investments made by these sub-managers more closely adhered to the sector allocations, the performance of the sub-managers could have been significantly improved. The MSRP Board advised that it was aware of and had discussed these issues but that it had not documented these discussions.

Furthermore, *MSRP's ICP Investment Policy and Guidelines* permits up to 60 percent of ICP funds to be invested in securitized investments. We question the reasonableness of this guideline given the current economic conditions and the fact that the primary purpose of the ICP is preservation of principal. In that regard, we noted that, as of September 30, 2008 and December 31, 2008, the percentage of total ICP funds that were in securitized investments (such as mortgage-backed instruments) was 45 percent and 35 percent, respectively.

- Certain sub-managers did not provide required monthly reports that would have provided information on detail investment holdings to the investment manager. The investment manager did not have this financial information as of November 2008 for four of the five sub-managers[4] and had to request this financial information from the sub-managers. MSRP management was unaware of what financial information sub-managers had, or had not, submitted. Furthermore, the detailed schedule of investment holdings subsequently provided by two sub-managers was incomplete (for example, lacked investment purchase prices). The other two sub-managers had not provided this financial information as of December 31, 2008. Agreements executed between the investment manager and the sub-managers required the sub-managers to provide this information to the investment manager on a monthly basis.

- Sub-managers did not provide required monthly reports that would have provided a summary and detailed breakdown of unrealized gains and losses by category of investment. Generally, an unrealized gain or loss is the difference between the book value (cost) of an investment in a portfolio and the corresponding market value of that investment. The cumulative reported unrealized ICP losses during the period from September 2008 to December 2008 ranged from $36 million to $57 million. The investment manager was unable to readily provide us a summary and detailed breakdown of unrealized gains and losses by category of investment. We were provided this information on unrealized losses for the period ending September 30, 2008 in March 2009, which showed that the majority of losses had occurred in asset

[4] One sub-manager was terminated by the MSRP Board during November 2008.

and mortgage backed securities ($23.5 million) and corporate bonds ($17.7 million). Agreements executed between the investment manager and the sub-managers required the sub-managers to provide this information to the investment manager on a monthly basis.

Recommendation 6
We recommend that MSRP

a. establish procedures, in conjunction with the investment manager, to adequately document the monitoring of the performance of the sub-managers and their compliance with *MSRP's ICP Investment Policy and Guidelines* and benchmarks, and that the MSRP Board adequately document discussions concerning contractor performance;
b. review the *MSRP's ICP Investment Policy and Guidelines* to ensure that the guidelines are consistent with the objectives of preserving ICP principal; and
c. ensure that sub-managers submit all required monthly reports.

Finding 7
Adequate monitoring related to the performance of the investment manager was not documented by MSRP management and the Board. For example, the investment consultant reported that the MSRP ICP was outperformed by more than half of other comparable ICPs during the periods measured, but there was no documentation that any action was taken by MSRP to address this issue.

MSRP management and the Board were not adequately documenting their monitoring of the performance of the investment manager. Although the Board advised that it did monitor the investment manager's performance, it did not document the monitoring or related subsequent actions. Nevertheless, certain issues were noted during our review that should have come to the attention of the Board for potential corrective action, as follows:

- The performance reports prepared by its investment consultant[5] indicated that the MSRP ICP was outperformed (overall rate of return) by comparable investment plans for the quarters ending September 30, 2008 and December 31, 2008, as well as for the three-year and five-year periods ending December 31, 2008. The investment consultant advised us that this result means that more than half of the investment plans in this peer group (that is, stable value managers) outperformed the MSRP ICP during the periods measured. However, the consultant did not use this measurement to evaluate the performance of the investment manager. Rather, the

[5] MSRP has a separate contract with an investment consultant to independently advise the Board and MSRP.

consultant used another measurement source that was primarily comprised of U.S. Treasury bills, even though, generally, only a small portion of the ICP is invested in U.S. Treasury bills. While the performance reports indicated that the ICP outperformed this measurement source, this performance should have been expected given that this measurement source consisted primarily of a U.S. Government security that paid a considerably lower interest rate. As such, we question the appropriateness of the Board's use of U.S. Treasury bills as a means to measure the performance of the investment manager.

- We noted that the investment consultant used incorrect financial information to evaluate the performance of the investment manager. Specifically, the investment consultant erroneously evaluated the investment manager's performance using the book value of the ICP portfolio value instead of the portfolio's market value. For the quarter ending December 31, 2008, the book value of the ICP portfolio exceeded the market value by $48 million. Furthermore, just as the investment manager had issued a disclaimer on calculations that it prepared (see Finding 4), the investment consultant also disclaimed any liability relating to the accuracy of its calculations since the consultant's evaluation of the investment manager's performance was based on financial information that it received from the investment manager.

- The investment consultant advised us that, although it had the ability to rate the investment strategy of the ICP, it had not been asked to do so by MSRP, even though this investment option was the most popular option offered by MSRP, with a portfolio balance of $729 million as of December 31, 2008. The investment consultant did rate the strategy of other MSRP investment options with smaller portfolio balances.

- In February 2007, the investment manager prepared a special report on the effect of the housing downturn on the ICP's investments in asset backed securities. Although this report was provided to the Board in February 2007, the earliest documentation of the Board's discussion of the report's conclusions was August 2007 (five months later). The report concluded that the ICP sub-managers anticipated the deterioration of the housing market and maintained defensive measures in their assets, and that the risk of significant losses to ICP participants over the next several months due to the decline in the housing market was minimal. However, as of September 2008, the unrealized losses in securitized investments totaled approximately $23.5 million ($10.9 million in asset backed securities, $7.8 million in mortgage backed securities and $4.8 million in commercial mortgage backed securities) and represented 56 percent of the total unrealized losses in the ICP portfolio. Furthermore, there was no documentation to substantiate that findings and conclusions of the investment manager’s report were closely reviewed, or that the investment manager was requested to reassess the potential impact on the ICP as the related conditions worsened.

Recommendation 7
We recommend that MSRP

a. **establish procedures to adequately document its monitoring of the investment manager’s performance (including corrective actions taken);**
b. **assess the adequacy of the benchmarks used to evaluate the performance of the investment manager;**
c. **consider requesting the investment consultant to rate the strategy of the ICP managed by the investment manager; and**
d. **closely review special reports on a timely basis, take appropriate action to protect the ICP portfolio, and document actions taken.**

Other Issues

Finding 8
Certain conditions recommended by MSRP’s legal counsel were not complied with.

Analysis
The original contract between MSRP and the investment manager, dated July 24, 2006, contained a provision that held the investment manager responsible for prohibited investments made by a sub-manager, such as the purchase of securities by a sub-manager through an affiliate of the investment manager. Specifically, the aforementioned provision was consistent with federal Employee Retirement Income Security Act (ERISA) standards, and with the related request for proposals which required fiduciaries to adhere to certain standards of diligence and conduct similar to ERISA standards. Nevertheless, in response to a request by the investment manager, MSRP’s legal counsel advised the Board that these standards were not required for this contract. Subsequently, on May 11, 2007, the investment manager requested MSRP Board approval to waive this provision, which, in essence, had the effect of holding harmless the investment manager for those sub-manager purchases previously not authorized under this provision of the agreement, including the purchase of securities by a sub-manager through an affiliate of the investment manager.

MSRP's legal counsel recommended to the Board that approval of the waiver be contingent upon the following conditions:

1. The investment manager affirm that it would not direct funds of a sub-manager into investments that are controlled by the investment manager,
2. This category of investments have a maximum size that is consistent with Board investment policy, and
3. MSRP staff conduct an analysis of investment patterns during the first year of operations and report to the Board on the actual position of investment manager securities in the funds selected by the sub-managers and the effect of investment manager transactions on these funds.

During the July 24, 2007 Board meeting at which this waiver was approved, the Board directed MSRP staff to develop written guidelines to periodically review the relationship between the investment manager, the collective funds, and the sub-managers to detect any prohibited investments. The Board further directed the staff to conduct such reviews and report to the Board's Investment Committee, as appropriate. We were advised by MSRP management personnel that, while written guidelines had not been developed, MSRP did have an ad hoc review process in place. However, MSRP could not document the performance of this ad hoc review process. Furthermore, there was no documentation to substantiate that the Board had addressed the other two conditions recommended by MSRP's legal counsel. Specifically, there was no documentation that the recommended affirmation had been obtained from the investment manager, and that the Board's investment policy had established a maximum size for the related investments.

Recommendation 8
We recommend that MSRP take immediate action to ensure that all conditions that were previously established by its legal counsel for approval of the waiver are complied with.

Finding 9
MSRP lacked documentation to substantiate that a financial relationship between the investment manager and a sub-manager it hired to invest ICP assets was disclosed to, and approved by, the MSRP Board.

Analysis
Documentation was not maintained to substantiate that a financial relationship between the investment manager and a sub-manager it hired to invest ICP assets was disclosed to, and approved by, the MSRP Board. During the course of our review, it came to our attention that the investment manager had an existing business relationship with a sub-

manager it had hired in March 2007 to provide services to the ICP. Specifically, the investment manager provided investment management services to an affiliate of the sub-manager. The investment manager advised us that this relationship was disclosed to the Board during the June 4, 2007 Board meeting. Although MSRP senior management personnel advised us that they were aware of this relationship, our review of the meeting minutes for that Board meeting disclosed that there were no documented discussions related to this potential conflict of interest. We discussed the general nature of this issue with a representative of the Maryland State Ethics Commission who advised us that, if requested, it would provide MSRP with applicable advice on potential conflicts of interest.

As of December 21, 2008, this sub-manager was responsible for managing approximately $152 million of ICP investments, which represented 20 percent of the ICP portfolio.

Recommendation 9
We recommend that MSRP

a. **present this matter to the Board and that the Board fully evaluate the appropriateness of this relationship and formally document its position in the related meeting minutes;**
b. **seek guidance from the State Ethics Commission regarding this matter (since, at a minimum, the relationship represents the appearance of a conflict of interest); and**
c. **take appropriate action based on the Board's position and the State Ethics Commission guidance.**

Finding 10
The Board and MSRP did not offer other conservative investment options (such as a money market fund) to participants in the 401(a), 401(k), and 457 Plans.

Analysis
The Board and MSRP did not offer an alternative conservative investment option (such as a money market fund) to participants in the 401(a), 401(k), and 457 Plans, even though such alternative investments are offered by certain other states. In this regard, a study prepared in 2008 by MSRP's investment consultant of other states' 457 Plan investment options disclosed that sixteen other states offered both a money market investment option and an ICP option in their 457 Plans. In contrast, MSRP offers a money market investment option only to 403(b) Plan participants,[6] which is restricted to educational affiliated employees (such as State educational institution employees). Money market investments comprise U.S. government securities, certificates of deposit,

[6] The ICP option is not available to 403(b) Plan participants.

and high quality commercial paper. In our opinion, these investments would offer a more conservative investment option to the ICP and would be in accordance with *MSRP's ICP Investment Policy and Guidelines*.

While MSRP management personnel advised us the investment consultant does not generally recommend that a Plan offer both an ICP and a money market option, as noted, the consultant's study indicated that a number of other states did offer both options. We were further advised by MSRP that contracts with ICP insurers might restrict MSRP from providing a money market option. However, MSRP could not provide us with the specific contract provision that restricted MSRP from offering an alternative conservative investment option to the ICP. Finally, MSRP and the investment manager advised us that offering the money market option could result in participant "confusion" when deciding which option to select. In our opinion, such an option would not be confusing if adequate descriptive information was provided to participants, including the fact that the risk of principal loss would be further minimized.

Recommendation 10
We recommend that the Board and MSRP consider offering an alternative conservative investment option (such as a money market fund) to 401(a), 401(k), and 457 Plan participants.

Exhibit 1
Investment Contract Pool
Fact Sheet

Maryland Teachers & State Employees Supplemental Retirement Plans
William Donald Schaefer Tower ~ 6 Saint Paul Street ~ Suite 200 ~ Baltimore, Maryland 21202-1608
Phone 410-767-8740 or 1-800-543-5605 Fax 410-659-0349

Investment Contract Pool
Separate Account Report as of September 30, 2008

DB Advisors
Deutsche Bank Group

Objective

The MSRP Investment Contract Pool ("ICP") seeks to preserve principal value and provide a relatively stable rate of return comparable to intermediate fixed-income yields over two to five years.

ICP Characteristics

Assets	$691 million USD
Average Credit Quality (See Credit Profile)[1]	AA+
Average Duration	3.20
Previous quarterly crediting rate (annualized)	4.39%
Upcoming quarterly crediting rate (annualized)	4.40%
Inception Date	1987
Investment Manager	DB Advisors[2]

Investment Overview

The ICP invests in a diversified portfolio of stable value contracts issued by banks, insurance companies, and other financial institutions, and a variety of fixed income instruments including U.S. Government and agency securities, mortgage-backed securities, asset-backed securities, and corporate bonds. Investors earn the average return received under all contracts in effect at any point in time. The ICP's return is affected by the general level of interest rates as well as by cash flows, including those from employer and employee contributions, withdrawals, and transfers into and out of the ICP. The average duration of the ICP's investments will be approximately two to four years. The average credit quality of the ICP's investments will generally be AA (or its equivalent), although individual securities or contracts purchased for the ICP may have a lower credit quality rating.

Sector Allocation[3]

Agency	6.6%
Asset Backed	5.1%
CMBS[5]	6.7%
Corporate	19.7%
Mortgage Backed	33.4%
STIF & Cash Equivalent	6.6%
US Treasury	12.3%
General Account GICs	4.4%
Wrapper Exposure[6]	5.3%

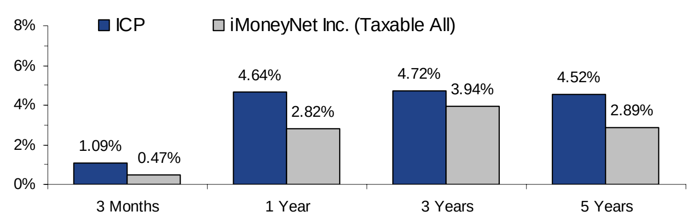
Credit Profile[3,4]

A-1	5.9%
AAA	66.1%
AA+	0.7%
AA	10.3%
AA-	0.6%
A+	0.7%
A	5.2%
A-	1.8%
BBB+	2.9%
BBB	4.9%
BBB-	0.9%
BB+ & Below	0.1%

Risks

Like all investments, the ICP has risks. There is a possibility that the ICP may not achieve its investment objectives. If an issuer of a contract or a fixed income security defaults on its obligations, the ICP may not maintain its principal value. To minimize this risk, the ICP's investment managers regularly monitor credit ratings and financial strength of the issuers of contracts and fixed income securities.

Performance[6]



[1] Represents the weighted average credit quality.
[2] Prior to July 2006 ING Stable Value Product Group, a division of ING Life Insurance and Annuity Company provided management services.
[3] Allocations shown are not necessarily indicative of future allocations. Figures may not sum to 100% due to rounding.
[4] As rated by Standard & Poor's or equivalent by any other rating services.
[5] Commercial Mortgage Backed Securities
[6] Wrapper exposure represents the difference between the book value of the wrapper contracts and the market value of the underlying fixed income securities as a percentage of the book value of the entire Fund. A positive wrapper exposure denotes that the Fund's book value exceeds the market value of the underlying assets and the issuer of the wrapper contract has a potential liability to the Fund. A negative wrapper exposure means that the market value of the underlying assets exceeds the book value of the wrapper and the Fund may have a potential liability to the contract issuer.
[6] Performance shown is net of Investment Management fees. Past performance is not indicative of future results. Figures greater than one year are annualized. The returns herein are not necessarily indicative of the returns that may be achieved over the longer term. There is no assurance that comparable returns will be achieved in the future or that the ICP's investment objective will be achieved. The results portrayed reflect the reinvestment of dividends and other earnings. The iMoneyNet Inc. Money Fund Report Averages is a service of iMoneyNet Inc. (formerly the IBC Financial Data Inc.) and are averages for categories of similar money market funds. Investors cannot invest in an average.

MSRP
Maryland Teachers & State Employees Supplemental Retirement Plans
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Phone 410-767-8740 or 1-800-543-5605 Fax 410-659-0349

Investment Contract Pool

Separate Account Report as of September 30, 2008

DB Advisors
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Strategy Overview

Assets in the Investment Contract Pool are held in trust for the benefit of participants of the MSRP. Participant investments made in the ICP are credited with a daily blended interest rate. Each quarter an anticipated, but not guaranteed, rate is declared. This quoted rate is net of all fees and expenses directly related to the ICP. This average annual expense fee will vary, but typically is approximately 0.35%, annualized. This fee does not include the monthly asset fee assessed on all participants by the Maryland Board of Trustees ("Board") and Nationwide Retirement Solutions, which will total 0.19%, annualized.

The ICP typically invests in the following investments: (1) Short term cash investments that are primarily available for participant daily liquidity needs; (2) Stable value pooled funds, which are stable value commingled bank trusts; (3) General Account Investment Contracts ("GICs" or "BICs"), which are issued by insurance companies or banks and maintain a constant principal valuation while earning interest; and (4) Synthetic GICs, which also allow for principal stability while earning interest. The key difference is that Synthetic GICs are the result of fixed income portfolios owned by the ICP and managed by independent fixed income managers, which generate investment income to pay interest, combined with wrapper contracts issued by insurance companies, banks, and other high-quality financial institutions, which help maintain the principal stability of the ICP.

ICP Investments[7,8]

Short Term Investment Funds (STIF)		
Bank of New York Government STIF	A-1	4.6%
General Account GICs		
Jackson National Life Ins. Co.	A1/AA/AA	2.9%
Prudential Insurance Co.	Aa3/AA/AA	1.5%
Synthetic GICs / Wrapper Issuers		
Bank of America, N.A.	Aaa/AA+/AA-	24.2%
Natixis Financial Products Inc.	Aa3/AA-/A+	28.7%
Royal Bank of Canada	Aaa/AA-/AA	24.2%
Monumental Life Insurance Co.	Aa3/AA/AA+	13.9%

Fixed income portfolios within Synthetic GICs[8,9]

Aberdeen Asset Management	17.2%
The Hartford Investment Management Company	22.5%
Goode Investment Management, Co.	10.2%
Pacific Investment Management Company	18.9%
Western Asset Management Company	17.0%

ICP Investment Policy

The ICP is managed according to a detailed investment policy established by the Board, which is available upon request.

Further Information

For information about the Maryland Supplemental Retirement Plans, investment option booklets, and other general information or to arrange educational seminars, please go to the MSRP website at www.msrp.state.md.us. For additional information about the Plans, financial planning calculators, performance information, mutual fund prospectuses, Plan forms, and to enroll or access an account, please log on to the Nationwide Retirement Solutions MSRP participant website at www.MarylandDC.com.

You may also call the MSRP at 410-767-8740 / 1-800-543-5605 (office hours: Monday thru Friday, 8:30 a.m. to 5:00 p.m.) or e-mail us at info@msrp.state.md.us. Or you may call the Nationwide Retirement Solutions Team MSRP Customer Service Center at 1-800-545-4730.

7 Ratings are Moody's Investor Services, Standard and Poor's Ratings Service, and Fitch, or its equivalent as determined by the manager, respectively.
8 Allocations shown are not necessarily indicative of future allocations. Figures may not sum to 100% due to rounding.
9 Fixed income portfolios managed by these fixed income advisors are combined with benefit responsive wrapper contracts to form Synthetic GICs.

The MSRP Investment Contract Pool is not a mutual fund, therefore there is no prospectus. It is a separately managed account, which may utilize collective investment trusts as part of its investment strategy. Unit price, yield, and return may vary.

APPENDIX

William Donald Schaefer Tower
Suite 200
6 Saint Paul Street
Baltimore, Maryland
21202-1608

Telephone: 410–767–8740
Toll-Free:: 1–800–543–5605

TTY: Use 711 in Md.
Or 1–800–735–2258

Fax: 410–659–0349

Visit the MSRP Board website at
www.MSRP.state.md.us

Call About the Plans,
or to Enroll
1-800-545-4730
or Enroll on-line at
www.MarylandDC.com

October 7, 2009

Mr. Bruce A. Myers, CPA
Legislative Auditor
State of Maryland
Office of Legislative Audits
State Office Building, Room 1202
301 West Preston Street
Baltimore, Maryland 21201

Dear Mr. Myers:

The Board of Trustees for the Maryland Teachers and State Employees Supplemental Retirement Plans (MSRP) has reviewed the draft report of the "Special Review" conducted of the Maryland Supplemental Retirement Plan's Investment Contract Pool (ICP). As requested, the Board's responses to the findings in the report are attached.

The MSRP Board values the role of the Legislative Auditor and has engaged in productive discussions with the auditors for the past few months in an effort to work toward adequately resolving the findings and implementing recommendations, as appropriate. While the MSRP Board may not agree with all aspects of the auditor's analysis related to the findings, the Board has generally agreed to implement the audit recommendations. In addition, MSRP engaged a consultant to assist in addressing issues raised by the auditor. The consultant's report was issued in July 2009.

With regard to the key issue concerning the disclosure of unrealized losses, the MSRP Board believes that the ratio or percentage of exposure method (rather than estimated dollars of unrealized losses), which was adopted in 2008, is appropriate and adequate disclosure, and a more meaningful number for participants as it can be applied to their individual account balances. In addition, the Board believes that unrealized losses are adequately disclosed in the current materials and allow participants to make informed investment decisions. Moreover, the ICP is designed to pay participants the book value of their investments as opposed to the current market value, so the only direct impact on individual investors of any unrealized loss in value may be a lower crediting interest rate. Finally, the August 30, 2009 report to the Board Investment Committee indicated that the current unrealized loss value related to the ICP is approximately $16.9 million, or 2.3% of the book value of the fund.

The Office of Legislative Audits (OLA) also stated that MSRP and its Board need to improve documentation of the monitoring and management of the ICP. The consultant report issued in July 2009 concluded that oversight by the Board and staff is more than adequate and even above average as compared to oversight practices seen with other public defined contribution plans. Notwithstanding the consultant's affirmation of current oversight practices, MSRP has taken steps, as recommended by the consultant and the Legislative Auditors, to improve monitoring and documentation. An ongoing independent verification of the reported market value of ICP investments, as well as of the accuracy of the interest rates calculated by the investment manager that were used to credit earnings to participant accounts, is currently being performed. In addition, MSRP staff has developed a Compliance and Monitoring Matrix that ensures various reports to monitor performance are properly provided to the Board. Finally, the Board also has taken additional steps to ensure that the monitoring efforts of the sub-managers, and any subsequent action taken as a result of substandard performance, are adequately documented.

The Board believes that we have been responsive to the auditor's concerns and that adequate and appropriate documentation, monitoring, and disclosures are in place that fulfill our fiduciary responsibility and continue to protect Plan participants.

Finally, it is important to note that the Legislative Auditor's review was initiated after an allegation was received via the OLA "Fraud, Waste and Abuse Hotline" regarding possible lack of disclosure of losses incurred by the ICP. However, it is our understanding that the auditors did not believe that the allegation suggested that there was fraud, and for that reason the auditors did not treat their review as a fraud investigation. It is our further understanding that no indication of fraud was discovered as a result of the auditors' special review.

If you have any questions or need additional information, you may contact me at 410-767-8733 or mhalpin@msrp.state.md.us.

Sincerely,

Michael T. Halpin

Michael T. Halpin
Executive Director

cc: Chairperson and Members, MSRP Board of Trustees
John K. Barry, Assistant Attorney General

Responses to Legislative Audits Findings and Recommendations
Special Review: Board of Trustees of the Maryland Teachers and
State Employees Supplemental Retirement Plans Investment Contract Pool
October 2009

Finding 1
MSRP did not adequately disclose unrealized losses of ICP principal to existing and prospective plan participants even though this information was provided monthly to MSRP and the Board. As of December 2008, the unrealized losses totaled approximately $48 million.

Recommendation 1
To foster transparency, we recommend that MSRP specifically disclose the actual dollar amount of ICP unrealized losses or gains to existing and prospective plan participants on an ongoing basis, and provide a plain language description of the wrapper exposure.

RESPONSE 1

The MSRP agrees with the factual accuracy of the audit finding prior to the publishing of the September 2008 quarterly fact sheet. MSRP, at this time, does not agree with the audit recommendation to disclose the actual dollar amount of ICP unrealized losses or gains; however, MSRP will consider providing a plain language description of the wrapper exposure.

The MSRP Board developed and published updated participant communication materials for the ICP. The ICP fact sheet and the ICP Overview document have been periodically updated and improved to reflect the best experience of staff, other retirement plans, advisers and investment managers. By the end of 2007, market weakness and volatility led the Board and the investment manager to begin additional reports and changes to regular reports. As of the September 2008 quarter, the ICP fact sheet for participants was changed to report percentage Sector Allocations of the underlying investments and to specifically identify wrap agreement exposure, e.g., the market to book ratio or "unrealized losses or gains". At that time, this percentage had just recently reached five percent of the total. It is important to note that prior to the September 2008 quarterly ICP fact sheet, the market to book ratio or unrealized losses were less than 3% of the ICP, well within the normal range for stable value funds.

In July 2009, the Board received an ICP assessment report from an independent consultant. This report concluded that the wrapper disclosure in the ICP fact sheet was more than adequate and exceeded that of other similar plans. In addition, the independent consultant repeated the cautions previously advised to the Board by the investment manager regarding changes to ICP participant communication materials (including disclosing a dollar value) that might be interpreted as an attempt to induce participant behavior regarding investments and which therefore could be alleged to violate certain wrap contract provisions unless provider consent was obtained. Failure to receive this consent could give a wrapper provider an excuse to assert the right to deny some or all of their book value coverage. The independent consultant's final recommendation was that the disclosure should remain unchanged with no further modification of disclosures.

This recommendation is also consistent with a study conducted in March 2009 by the Board's regular investment consultant. This review examined stable value profile sheets from governmental units with similar plans. It noted that Maryland's fact sheet generally provided more information than other plans surveyed. None of the other sheets included any information regarding market to book value. In fact, very few fact sheets disclosed any information about wrap exposure—none stating other than a percent.

The MSRP Board, based on this advice, consultation and consideration, believes that the ratio or percentage method adopted in 2008 is appropriate and adequate disclosure. The Board's concern is not that disclosure of a specific dollar amount of unrealized ICP losses would be confusing to plan participants; instead it is that the more appropriate and relevant number for the participant is the percentage of the exposure, which can be applied to a participant's individual account balance. MSRP believes that unrealized losses, as well as basic and critical financial information, should be and are adequately disclosed in the current materials and that these materials allow existing and prospective plan participants to make informed investment decisions. However, the Board will consider providing a plain language description of the wrapper exposure, as recommended by the auditors.[1]

As of the August 31, 2009 monthly report presented to the MSRP Board Investment Committee, the current unrealized loss related to the ICP is approximately $16.9 million or 2.3% of the book value of the fund.

Finding 2
ICP unrealized losses were not disclosed in MSRP's 2007 audited financial statements.

Recommendation 2
We recommend that MSRP

a) *disclose the fair value of the ICP investments in its annual audited financial statements, as required by applicable accounting principles; and*
b) *ensure that the existence of ICP investments is periodically confirmed with the custodian's bank.*

<u>RESPONSE 2</u>

The MSRP agrees with the factual accuracy of the audit finding and has already implemented the audit recommendations.

a) The 2007 Plan financial statements were reconciled and reported using the traditional practice of reporting book value. The 2008 audited financial statements also reported book value, but with a disclosure of market value in the accompanying footnotes. Both the book value and market value of the ICP investments will be disclosed in future financial statements as required by applicable accounting principles.

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[1] **<u>Auditor's Comment</u>**: MSRP believes that its current disclosure of the percentage of ICP unrealized losses is appropriate and adequate. Although we do not dispute that MSRP's disclosure of ICP unrealized losses is now consistent with industry practices, we believe that disclosing the actual dollar amount of unrealized losses would improve participant understanding of investment risk. MSRP also states that changes to participant communication materials could be considered an attempt to induce participant investment behavior and, therefore, could be construed as a violation of the wrapper contract provisions. However, including the actual dollar amount of unrealized losses is merely providing participants with the same unrealized loss information that is already presented (as a percentage), but in a simplified format. Accordingly, we continue to believe that disclosing such amounts would enhance transparency.

The reporting of book value only in the financial statements for these types of investments was consistent with accounting standards in previous years. The Governmental Accounting Standards Board (GASB), the Federal Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) all currently acknowledge that book value is the relevant and appropriate measure for valuing fully benefit-responsive investment contracts held by state and local governments because book value is the value that will ultimately be realized by plan participants. An informal MSRP survey of other governmental entities, conducted by MSRP staff in 2008, concluded that MSRP use of book value reporting was consistent with how other governmental entities reported stable value funds in their financial statements.

Statement of Position (SOP) 94-4, issued by the AICPA, was amended by FASB Staff Position (FSP) AAG INV-1 and SOP 94-4-1. These documents effectively changed the reporting requirements that required both the book and market values to be noted in the financial statements. This change became effective for financial statements for plan years ending after December 15, 2006. MSRP was not fully made aware of this change in the accounting standards until presented with this finding.

As noted in the MSRP July 24, 2007 Board meeting minutes, the auditor indicated that their preference was to report using market value but would continue the Board's practice of reporting ICP assets at book, not market value. While agreeing to report ICP assets at book value, the auditor did not suggest to MSRP to, in addition, disclose the market value in the accompanying footnote, which is in compliance with applicable accounting standards.

b) The Board's independent accounting firm has been instructed to verify and confirm the existence of the ICP investments with the custodian bank as part of the work conducted to prepare the audited financial statements. These procedures were implemented with the preparation of the 2008 audited financial statements. Furthermore, MSRP implemented an additional verification process as of the quarter June 30, 2009.

Finding 3
MSRP lacked documentation to substantiate that the market value of ICP investments, reported by the sub-managers to the investment manager (and forwarded to the MSRP Board), had been independently verified.

Recommendation 3
We recommend that MSRP obtain, on a periodic basis (at least quarterly), independent verifications of the market values of investments held by the ICP.

RESPONSE 3

While MSRP and the Board believe that the independent pricing policy used by the sub-manager provided a reasonable level of assurance, the Board has implemented the audit recommendation to provide further verification of the values of investments held by the ICP.

In April 30 2009, MSRP procured an independent valuation service from its custodial bank. The independent valuation from the custodial bank performed in April 2009 on all securities discloses no variance of pricing more than 0.1% for the total portfolio. This conclusion was further confirmed by the independent consultant, as part of the special review conducted.

Each sub-manager has a written portfolio pricing policy. In summary, three sub-managers use a process that relies on an independent third party vendor pricing service. If a price for a security is unavailable from the vendor pricing service, the sub-manager will typically use multiple broker prices to obtain the value of the security. In all events portfolio management staff for the sub-manager may not influence the pricing of securities that they manage. The fourth sub-manager uses an index strategy and, thus, relies on the pricing of the index provider. Each sub-manager also follows GIPS (Global Investment Performance Standards, formerly AIMR) compliance and undergoes independent verification. The three sub-managers that use an independent third party vendor pricing service also perform a pricing and holdings reconciliation monthly with the bank custodian. The sub-manager that uses an index strategy receives prices and reconciles account holdings with the index provider.

While the sub-manager's pricing policy appears to provide for independent verifications of the market values of the ICP investments, MSRP will continue to obtain the monthly independent valuation service from its bank custodian, reporting on a quarterly basis to the Board. This valuation reporting was implemented as of the quarter ending June 30, 2009. The custodial bank also continues to be contracted to safeguard and report asset holdings as it has been since April 2006. This verification was implemented as of the quarter ending June 30, 2009.

Finding 4
MSRP did not independently verify the accuracy of the interest rates used to credit earnings to participant accounts, even though the investment manager issued a written disclaimer as the accuracy of the interest rate calculations that is was responsible for preparing.

Recommendation 4
We recommend that MSRP

a) *work with the investment manager to eliminate the various disclaimers relating to the accuracy and validity of the crediting rate calculation, to the extent possible; and*
b) *establish a process to verify the accuracy of the crediting rate calculated by the investment manager.*

<u>RESPONSE 4</u>

MSRP and the Board believe the current methodology for calculating the interest rates used to credit earnings to participant accounts is reasonable and consistent with professional standards and that it was adequately monitored. However, the Board agrees to implement the audit recommendations.

a) The disclaimer referenced in the auditor analysis was obtained from internal reports between the sub-managers and the investment manager and was not on reports that the investment manager issued to the Board. This type of disclaimer is typical or standard language in the industry.

It is essential to note that the Assistant Attorney General reviewed and verified to the Board that these disclaimers do not lessen the investment manager's fiduciary responsibility under its contract obligations to manage the reporting process and report to the Board on any material difficulties or errors that come to their attention, or that should come to their attention. Regardless, MSRP has contacted the investment manager and will continue discussions regarding modification of the wording of the disclaimers.

b) While MSRP believes the current methodology for determining credited interest rates is reasonable and consistent with professional standards, MSRP agrees to establish a process to confirm the crediting rate calculated by the investment manager. MSRP already has procedures in place that will help implement this confirmation. MSRP receives custodial bank monthly reports of priced holdings, performance and guidelines compliance. As indicated in a previous response, MSRP implemented a quarterly custodial report of portfolio market values by sub-manager. MSRP staff will use the custodial market values to confirm the Crediting Rate. The results of these procedures will be documented and reported to the Investment committee each quarter.

Stable value funds, including the MSRP ICP, are managed with the objective of maintaining principal stability, generating a positive and reasonably stable rate of return, and providing liquidity at “contract value” for qualified participant-initiated transactions (also known as “benefit responsiveness”). Published accounting standards provide that stable value funds (1) carry synthetic investment contracts at contract value, also known as book value, which is deposited principal plus accrued interest on the wrapper’s set rate of interest, known as the crediting rate; (2) allow for the amortization of realized and unrealized gains and losses into future crediting rates of the contract; and (3) allow assets to be available for participant withdrawal at contract value (again “benefit responsiveness”). The amortization of gains and losses means that when market rates fall, a stable value fund’s yield and crediting rate is expected to fall, although more slowly than the current market interest rates. The reverse is also true. Thus, the situation noted by the auditors in their analysis (where the crediting rate resulted in a high rate of interest during a period when the ICP portfolio was experiencing unrealized losses) would have been expected. Again, the reverse will also hold true (i.e., the crediting rate will appear to be a low rate of interest when the ICP portfolio is experiencing unrealized gains). The formula and contract structure spreads gains and losses over a period of time, and this will be particularly evident in times of great volatility, as in 2008.

Finding 5
Wrapper (insurance) agreements executed with financial institutions to cover investment losses appear highly complex and ambiguous, and MSRP was unable to clearly explain how the agreements preserve the investment portfolio. Furthermore, certain of these agreements were apparently not signed until after we requested them.

Recommendation 5
We recommend that MSRP

a) *in conjunction with the Office of the Attorney General, obtain clarification about how the agreements protect the ICP investment portfolio, including the circumstances under which payments are made under the agreements, and the timing of such payments;*
b) *maintain current signed wrapper agreements; and*
c) *monitor the financial status of wrapper providers, and take appropriate measures in the event an insurer falls below MSRP's established credit threshold.*

<u>RESPONSE 5</u>

While we agree that the wrappers agreements are technical and complex documents, we disagree they are ambiguous but, instead acknowledge they are written so as to provide appropriate safeguard and protections. However, to document this and ensure best practices, the Board agrees to implement the audit recommendations.

a) Wrapper providers for synthetic guaranteed investment contracts do not make payments to cover particular losses as incurred on individual securities. As described in the special consultant's report, their obligation is to pay any difference between book and market value (i.e., referred to as "unrealized loss") at the end of a book value termination period elected by the Board or in certain other limited circumstances, such as if the fund were to be depleted through extensive participant withdrawals. The length of this termination period is controlled by the duration of the securities that are "wrapped". During this period securities are gradually liquidated through sale or maturity, with continual adjustment of the credited interest rate so that, at the end of the period, book and market value may be equalized. The contracts also provide that participants may continue to withdraw funds at book value during this period, and that the interest rate may not fall below zero. If book and market value of the fund are not equal at the end of the termination period, the wrapper providers are obligated to make up the difference by paying money to the ICP. Contrary to concerns expressed in the audit report, ICP agreements do not permit the wrapper providers to perpetually extend this termination period, which is always limited by the underlying duration of the securities.

   As noted in the consultant's report this type of termination (which gradually converts the fund into a short term investment pool, similar to a money market fund) is rarely exercised. Instead, stable value funds will typically opt to either negotiate a termination methodology or transfer assets to a new contract provider.

   MSRP has requested documented clarification and confirmation on these matters from the Office of the Attorney General, including a legal description of how the agreements protect the ICP investment portfolio, the circumstances under which payments are made to the ICP under the agreements, and the timing of such payments. The Office of the Attorney General expects to deliver this advice later in the month of October.

b) MSRP currently has a complete copy of all signed wrapper contracts on file and will continue to maintain a copy of these agreements, updating the files as necessary.

c) The investment manager is required to notify the Board when the credit rating for a wrapper provider falls below the standard permitted by the ICP Investment Policy. In such event, the investment manager would also be obligated by contract to find an appropriate substitute, or present alternative resolution methodologies to the Board. This is part of their general obligation to manage the ICP according to the conditions expressed in the policy.

   In addition to the investment manager's responsibilities, MSRP has also implemented additional procedures to monitor the financial status of wrapper providers. As recommended in the special consultant report, MSRP staff receives a news/Web alert for each of the wrap providers and receives regular weekly reports of events, analysis and commentary. The investment manager has been notified to continue to make regular reports of significant developments regarding all parties servicing the ICP as well as to make reports of events as they happen. Both the investment manager and the investment consultant have been directed to provide alerts of significant events such as ratings changes. All such significant information is and will be delivered to the Board of Trustees members as received.

   Furthermore, as part of their regular quarterly written report for Board meetings, the investment manager includes a summary of any significant developments involving wrap providers, sub-managers, or the bank custodian. The quarterly reports include the current credit rating for each wrapper. This is compared to the ICP Investment Policy requirement that states “Issuers of Book Value Contracts must be rated the equivalent of AA- or higher by at least one of the above rating services at time of purchase.” If the credit rating is not in compliance with the ICP Investment Policy, it would be noted in the quarterly report. A rating substantially below that standard would require detailed analysis, evaluation and consultation by the MSRP Board in conjunction with the investment manager. We believe this procedure will address the audit recommendation to monitor the financial status of wrapper providers, and take appropriate measures in the event an insurer falls below MSRP's established credit threshold. The review of these reports and related discussions will be more fully documented in the Board meeting minutes.

Finding 6
Monitoring of sub-managers performance was not adequately documented.

Recommendation 6
We recommend that MSRP

   a) *establish procedures, in conjunction with the investment manager, to adequately document the monitoring of the performance of the sub-managers and their compliance with MSRP's ICP Investment Policy and Guidelines and benchmarks, and that the MSRP Board adequately document discussions concerning contractor performances;*
   b) *review the MSRP's ICP Investment Policy an Guidelines to ensure that the guidelines are consistent with the objectives of preserving ICP principal; and*
   c) *ensure that sub-mangers submit all required monthly reports.*

RESPONSE 6

While the Board disagrees with certain aspects of the audit analysis, the Board agrees to implement the audit recommendations to ensure best practices.

a) Documenting Monitoring of the Performance of the Sub-Managers

The Board will assure adequate documentation of its monitoring of investment sub-managers' performance and compliance, including the Board's discussions on such matters. To address the finding, it is important to note the monitoring process that is currently in place. The MSRP Board has contracted with an investment manager to manage the ICP. The investment manager has fiduciary responsibility and is provided with discretionary authority, on behalf of the MSRP, to select stable value investment contracts and to exercise other delegated authority, which includes monitoring the overall strategy and the different participating parties, such as the fixed income sub-managers. The investment manager is not permitted to manage any underlying fixed income investments within the ICP, per their contract, but is responsible for selecting sub-managers to manage fixed income securities that are combined with wrapper agreements to form synthetic GICs.

The investment manager employs multiple sub-managers in the ICP. Each sub-manager brings different investment styles that may result in periods where one manager's strong cyclical performance will offset another sub-manager's weaker performance. Each sub-manager's portfolio assets are to be kept in compliance with provided investment guidelines, including duration, credit quality and sector constraints. However, since each sub-manager is expected to actively manage their assets, it is expected that the allocations of each sub-manager will differ, sometimes significantly, relative to the allocations of the benchmark as well as to the other sub-managers. Thus, deviations are expected.

The investment manager, as the overall stable value structure manager, monitors the sub-managers to review implementation of and any changes to investment strategy, reviews daily cash flow of the ICP, and oversees compliance by the sub-managers. The investment manager employs several functional groups to effectively monitor, including an Investment Support team, a Stable Value Group, a Credit and Research team, a Compliance team, and the Sub-Advisory Sub-Committee (SASC).

Specifically, the SASC is responsible for oversight of the sub-managers, from compliance, investment, legal, and business perspectives with representation from each area. The SASC performs due diligence reviews, performance reviews and reviews to ensure guideline compliance. The goal of the SASC is to combine sub-manager oversight under a single umbrella, provide internal communication and coordination with respect to monitoring and key decision-making with respect to the sub-advised relationship. As previously stated, this oversight is in accordance with the concept that each sub-manager differs in their investment styles and is designed as such so that those differences will help the overall ICP to remain stable.

The investment manager and its SASC accomplish their monitoring of the sub-manager through various activities:

- **Monthly**: The SASC meets on a monthly basis to discuss and assess each sub-manager over the recent short term period and to review the longer-term performance. On a monthly basis, the Stable Value Group reviews various sub-manager portfolio information and a standard account holdings report and, if needed, makes inquiries to sub-manager regarding intra-quarterly performance, exposures, or positioning of their account. The Stable Value Group also produces the investment manager's Stable Value System monthly ICP fund report that is sent to the MSRP staff. This report includes a check of contract balances and allocations, duration, credit quality, sector and credit exposure and performance. The Stable Value Group provides the SASC the “External Manager Reports” for each sub-manager, which are custom monthly sub-manager reports that contain detailed information on the fixed income assets under management for the ICP, including performance information and sector allocations of the sub-managers, as well as their respective benchmark indexes. The Compliance team is also provided these reports and reviews, in conjunction with the SASC, any compliance variations during the month, steps taken to rectify, and whether there is any required sub-manager reimbursement.
- **Quarterly**: The Compliance team receives a compliance report from each sub-manager, which is reviewed and material changes are reported to and evaluated by the SASC and the Stable Value Group. The Stable Value Group receives and reviews a quarterly reporting package from each sub-manager that includes holdings information, transaction information, commentary explaining the prior quarter's performance, strategy, and portfolio and market commentary. This information is used to prepare the ICP quarterly report which is presented at the quarterly MSRP Board meeting. An oral report is given when presenting the written ICP quarterly report at the Board meetings.
- **Annually**: Each sub-manager provides a written annual compliance report and due diligence report that includes information on executive management and key personnel changes, a review of the compliance functions, committees, reporting and testing processes; the results of any Securities and Exchange Commission or other regulatory inspections; a review of the internal audit procedures, business continuity and recovery plans and internal operations, systems, and trading procedures; change to risk management personnel or resources; the processes and rules surrounding counter-party risk management; derivative use and oversight practices; credit exposure monitoring process; size, depth, and experience of the portfolio management and research analyst team; and historical performance. Each sub-manager also meets with the Stable Value group and representatives of the SASC, which includes Compliance, Legal, Operations, and Risk team members, for additional due diligence discussions and to further review each account. All of this information is aggregated and reported to the SASC. At least annually, the SASC will make a determination whether each sub-manager remains approved, is put onto a watch list, or is to be terminated. This process has been in place and was used for the sub-managers referenced in the report. Over the past couple years, one sub-manager has been terminated while another sub-manager has been and is currently on the 'watch list'.

As noted above, the MSRP Board receives both monthly and quarterly reports. In addition, the quarterly ICP reports to the Board from the investment manager are distributed to the contracted investment consultant in advance of each meeting in order for the consultant to be able to provide commentary and evaluation of the quarterly status of the ICP at the upcoming Board meeting. The MSRP Board reviews the ICP quarterly report that indicates sub-manager performance over time. MSRP Board staff and the investment manager hold discussions regarding performance of the sub-managers, both informally intra-quarter and formally during the quarterly MSRP Board meetings. With the investment manager's advice, a sub-manager with consistent unsatisfactory performance without justification is placed on 'watch' and, if performance does not improve, is terminated. Over the past two years, one sub-manager has been terminated while another sub-manager has been and is currently on the 'watch list'.

The auditor's statement that “had the investments made by these sub-managers more closely adhered to the sector allocations, the performance of the sub-managers could have been significantly improved” is speculative with the benefit of hindsight. A sub-manager's deviation from investment allocations is not prohibited and does not require corrective action but is reviewed, in conjunction with the overall ICP, to ensure that it is in the best interest and consistent with the overall ICP strategy going forward. During the recent turbulent market, not one participant in the ICP lost principal value. In addition, in 2008 the ICP returned a positive 4.7% for participants. The ICP was one of only 2 investment options available to the MSRP 457, 401k and 401a plan participants that had a positive return in 2008, per MSRP records.

In the future, the MSRP Board will ensure that it documents its monitoring of the performance of the sub-managers and their compliance with MSRP's ICP Investment Policy and Guidelines and benchmarks. We recognize that many discussions held in the past, including the discussions held at the Board meetings, may not have been adequately documented to show evidence of this monitoring activity. Thus, the MSRP Board will, in the future, adequately document their discussions concerning contractor performances.

b) Review of the ICP Investment Policy and Guidelines
The MSRP Board regularly and at least annually reviews the MSRP's ICP Investment Policy and Guidelines. This review includes ensuring that the guidelines are consistent with the objectives of preserving ICP principal. Recently, the Board has requested that the investment consultant, investment manager and the independent consultant hired to conduct the special review each review the MSRP's ICP Investment Policy and Guidelines, specifically, to comment on whether the guidelines were consistent with the objectives of preserving ICP principal. All three consultants concluded that the current policy is consistent with the objective of “safety through preservation of principal and accrued income”. MSRP will continue to review regularly the Policy in order to determine if any revisions are appropriate. These reviews will be more fully documented in the appropriate Board meeting minutes.

c) Sub-Manager Submitting Required Monthly Reports
Sub-managers submit the required monthly reports, noted in the auditor analysis, directly to the investment manager. Per the investment manager, all required sub-manager monthly and quarterly reports and information have been provided as agreed upon between the investment manager and

the sub-managers. The investment manager has indicated that the auditors requested certain ad-hoc information (e.g., detailed breakdown of unrealized gains and losses by category of investment) that is not required to be provided within any reports required by any sub-manager Investment Management Agreement. The auditors, thus, may feel that such information should be included in future sub-manager reports. MSRP staff will work with the Legislative Auditors to explore what information they feel should be provided monthly. Those suggestions will be reviewed with the Board and the investment manager to determine if any revisions should be made to monthly reports required by the Investment Management Agreements.

Finding 7
Adequate monitoring related to the performance of the investment manager was not documented by MSRP management and the Board. For example, the investment consultant reported that the MSRP ICP was outperformed by more than half of other comparable ICPs during the periods measured, but there was no documentation that any action was taken by MSRP to address this issue.

Recommendation 7
We recommend that MSRP

a) *establish procedures to adequately document its monitoring of the investment manager's performance (including corrective actions taken);*
b) *assess the adequacy of the benchmarks used to evaluate the performance of the investment manager;*
c) *consider requesting the investment consultant to rate the strategy of the ICP managed by the investment manager; and*
d) *closely review special reports on a timely basis, take appropriate action to protect the ICP portfolio, and document actions taken.*

<u>RESPONSE 7</u>

While MSRP and the Board believe its procedures to monitor the performance of the investment manager are adequate, it does agree to implement the audit recommendations to ensure best practices.

a) **Procedures to Adequately Document Monitoring Investment Manager's Performance**
MSRP has contracted for several years with an investment consultant to assist the Board in monitoring and documenting the performance of all investment options in the Plans. Currently, the investment consultant provides quarterly reports that include performance of the ICP. In addition the Board regularly receives reporting from the investment manager that includes information on the performance of the entire portfolio as well as the individual sub-managers. As described in the response to finding 6, the investment manager has a detailed process for monitoring the sub-managers and regularly reports to the Board.

MSRP recently contracted with a special consultant to perform a review that included reviewing MSRP staff and Board oversight practices. The special consultant concluded that the current Board and staff oversight is more than adequate and even above average as compared to oversight practices of other public defined contribution plans. The special consultant did, however, suggest some additional monitoring steps to ensure best practices. The Board is implementing these recommendations. In addition, to better document monitoring efforts, MSRP staff has developed a Compliance and Monitoring Matrix that ensures various reports to monitor performance are properly provided to the Board.

In the future, MSRP staff will verify that discussions of these documents, specifically the investment manager's performance, are properly documented in greater detail in the Board Meeting minutes.

b) Assess Adequacy of the Benchmarks to Evaluate the Investment Manager's Performance
As described in the response to Finding 6, the investment manager is a manager of the sub-managers. There is no universally accepted benchmark to evaluate the performance of an investment manager that is customized to stable value funds, because stable value funds are often quite different in their structure and component strategies. However, MSRP has established an overall goal or benchmark for the ICP, as noted in the MSRP ICP Investment Policy and Guidelines. The Policy states that an objective of the ICP is to ensure that investments "exceed the returns on money market investments by 100 - 200 basis points per year over a full market cycle". Consistent with the ICP Policy, performance is evaluated against 91-day Treasuries plus 100 basis points. US Treasury Bills is the benchmark most often used to measure money market fund performance. The investment manager's performance is evaluated based on their contract requirements (e.g., delivering timely and accurate reports) and to the extent the ICP is complying with the MSRP ICP Investment Policy and Guidelines.

Consistent with being a stable value fund, performance is reported based on book value of the ICP. This is appropriate since participants in the ICP make withdrawals from the ICP based upon book value of their account. The book value of the account is supported by the wrap contracts which guarantee withdrawals, regardless of market activity. Reporting performance based on book value is also consistent with industry standards for stable value portfolios.

As another measure of the investment manager's performance, the investment consultant compares the returns of the ICP to a universe of other stable value managers. Per the investment consultant's experience, this is in line with performance reporting for other defined contribution plans monitoring similar investment options. As pointed out in the auditor analysis, the ICP underperformed the median in its peer group for the three and five year periods ending December 31, 2008. It is important to note, however, it did so by only 0.10% in each period, reflecting a very small margin of underperformance.

As noted in the auditor analysis, the investment consultant prepares performance reports for the Board to use in evaluating the performance of the investment manager. The MSRP Board agrees to review the Policy to determine if US Treasury Bills plus 100 basis points is the most appropriate benchmark for the ICP.

c) Requesting the Investment Consultant to Rate the Strategy of the ICP

As confirmed with the investment consultant, the customized nature of the ICP makes it inappropriate to rate the investment manager using the consultant's rating system used for other asset classes. The ICP is a portfolio customized for the MSRP by the investment manager. Customization for the portfolio includes the selection of sub-managers as well as the inflow and outflows of assets specific to the MSRP ICP. The rating system used by the investment consultant compares managers with similar investment strategies. The investment consultant currently does not rate any stable value portfolios for clients due to the customized nature of these products. The investment consultant will continue to monitor and report on ICP performance. MSRP will contact the Legislative Auditors to discuss the investment consultant's position in order to determine what further action the auditors feel should be taken with rating the strategy of the ICP.

d) Review Special Reports on a Timely Basis

The February 2007 special report of the investment manager, as noted in the auditor analysis, was provided to Board members in February 2007. Discussions were held on the report prior to the August 20, 2007 Board meeting, but the discussions were not sufficiently documented. It was decided to formally put this report on the August 20, 2007 Board agenda for further discussion, along with a report prepared by the investment consultant on sub-prime mortgages.

To address the audit concerns, the Board will address the action to be taken for special reports received at the next meeting following when such reports are issued. If not on the agenda for the next meeting, at minimum, the Board meeting minutes will reflect that the Board has received the special report and, if applicable, the justification why the Board has decided to table discussion for a future meeting.

The Board will continue to protect the ICP portfolio. All monitoring efforts will be documented and available for future verifications.

Finding 8
Certain conditions recommended by MSRP's legal counsel were not complied with.

Recommendation 8
We recommend that MSRP take immediate action to ensure that all conditions that were previously established by its legal counsel for approval of the waiver are complied with.

<u>RESPONSE 8</u>

The Board disagrees that certain conditions recommended by MSRP legal counsel were not complied with; however, the Board does recognize that formal documentation that provided specific evidence of this was insufficient. The Board will take immediate action to ensure that such formal documentation is obtained.

The conditions recommended by legal counsel were offered due to a concern that different types of collective funds (such as mutual fund or collective fund effectively controlled by the investment manager) might be used for this strategy, or that unapproved bond purchase programs might be adopted. It is important to note that neither situation has occurred. The Investment Manager has not directed sub-manager allocations into collective funds that it controls. Instead, the collective funds used in the ICP are index funds managed by an independent index provider (i.e. that does not have any relationship with the investment manager).

To address the specific legal counsel recommendations, approval of the waiver was to be contingent upon the following conditions:

1) This condition is noted in the auditor analysis as "the investment manager affirm that it would not direct funds of a sub-manager into investments that are controlled by the investment manager." As noted in the related Board minutes (July 24, 2007 meeting) that approved the waiver:

   "The Committee therefore recommended a contract modification under the following terms and conditions

   (1) The general rules of fiduciary conduct will still apply and be affirmed in the waiver itself, e.g., (investment manager) could not direct or attempt to direct transactions between the collective investment vehicle and (investment manager) affiliates."

With the approval by the Investment Manager of the contract amendment, the investment manager has complied with this first condition. No additional document would be necessary.

2) MSRP staff has confirmed that the category of investments (related to the waiver) have remained consistent with the plan expressed by Investment Manager at the inception of the strategy. This plan is consistent with the Board investment policy.

3) MSRP staff has included monitoring of the enhanced index strategy in the aforementioned Compliance and Monitoring Matrix and implemented review of monthly sub-manager reports. Staff is scheduled to report quarterly to the Board Investment Committee regarding conformity of ranges and types of investments as specified in the sub-manager's investment management agreement.

MSRP staff reviews, as well as documentation supporting conditions #1 and #2, will be presented to the Board at an upcoming Board meeting in order to formally report and document compliance with these conditions.

Finding 9
MSRP lacked documentation to substantiate that a financial relationship between the investment manager and a sub-manager it hired to invest ICP assets was disclosed to, and approved by, the MSRP Board.

Recommendation 9
We recommend that MSRP

a) *present this matter to the Board and that the Board fully evaluate the appropriateness of this relationship and formally document its position in the related meeting minutes;*
b) *seek guidance from the State Ethics Commission regarding this matter (since, at a minimum, the relationship represents the appearance of a conflict of interest); and*
c) *take appropriate action based on the Board's position and the state Ethics Commission guidance.*

RESPONSE 9

The Board agrees with the factual statement made by the auditors that documentation was lacking. The Board has complied with the majority of the audit recommendations, with the formal documentation of the Board's position to be documented during the next quarterly Board meeting in November 2009.

a) As noted by the auditors, the relationship in question was disclosed to the Board during the June 4, 2007 Board meeting. The Board has been aware of this relationship and had previously determined that there was no conflict of interest concern. However, also as noted by the auditor analysis, this disclosure and the Board's approval were not adequately documented in the Board meeting minutes.

   In order to properly document the disclosure of this relationship, the investment manager presented an extensive report on the sub-manager selection process at the Board meeting in June 2009. After reviewing the report, the Board agreed with the report that there was no information indicating any conflict of interest, and the selection this sub-manager complied with all ERISA rules.

   At the June 2009 meeting, however, the Board did direct legal counsel to follow-up on the issue with the State Ethics Commission, as suggested by the Legislative Auditors. The results of this follow-up will be disclosed again to the Board at the next Board meeting so that the Board can formally document its position on the financial relationship between the investment manager and a sub-manager it hired to invest ICP assets.

b) In compliance with the OLA recommendation, a letter dated June 18, 2009 was sent from the Board counsel to the Executive Director of the State Ethics Commission concerning this matter to seek guidance. The reply from the Executive Director indicated that the Ethics Commission has no jurisdiction in a matter of this type. Additional discussions with the Executive Director did not offer any informal guidance.

c) Given the above actions taken, no further action is necessary.

Finding 10
The Board and MSRP did not offer other conservative investment options (such as a money market fund) to participants in the 401(a), 401 (k), and 457 Plans.

Recommendation 10
We recommend that the Board and MSRP consider offering an alternative conservative investment option (such as a money market fund) to 401(a), 401 (k), and 457 Plan participants.

RESPONSE 10

The Board agrees with the factual statement of the finding. However, after careful consideration, believes it is not in the best interest of the participants, at this time, to offer an alternative conservative investment option.

The Board has performed biennial reviews of the investment options of the plans with assistance from the investment consultant and has made consistent determinations against offering an alternative conservative investment option (such as a money market fund) along side the ICP. Neither the investment consultant nor the independent consultant that conducted a special review recommended having both a stable value and a money market fund in the MSRP 457, 401 (k) and 401(a) plans. Reasons given included that offering such an option would require the implementation of an equity wash* that can be confusing to participants and difficult to monitor and implement by the plan. In addition, both consultants noted that stable value has historically outperformed money market funds with comparable risk and, in their experience, is preferred by participants.

In addition, in a memo dated August 13, 2009, legal counsel cited specific contract language that restricts MSRP from offering an alternative conservative investment option to the ICP. Further noted in the memo is that, in offering such an additional option, wrapper agreements could be affected and, as noted above, an "equity wash" would be required.

The Board will continue to perform its biennial reviews to consider offering alternative investment options; however, at this time and given the reasons noted above, MSRP will not offer an alternative conservative investment option.

*The Stable Value Investment Association describes an *equity wash* as:

"A provision in a stable value product that any transfers made from the stable value fund must be directed to an equity fund option of the plan for a stated period of time (usually 90 days) before said transferred funds may be directed to any other plan-provided competing fixed income fund (such as a money market fund.) This provision is intended to reduce interest rate arbitrage by plan participants, thus permitting stable value contract issuers to underwrite the plan without excessive risk exposure."