

Fiduciary Performance Audit of the State Teachers Retirement System of Ohio

Conducted on Behalf of the
Ohio Retirement Study Council

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Introductions

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Overview

- The Funston Advisory Services (FAS) team began our fiduciary performance audit of STRS during October 2021; the final report was submitted in May 2022.
- We reviewed six major areas, as specified in the RFP:
 1. Board Governance and Administration;
 2. Organizational Structure and Staffing;
 3. Investment Policy and Oversight;
 4. Legal Compliance;
 5. Risk Management and Controls; and
 6. IT Operations.

Process

- Our fiduciary audit approach and activities included:
 - Review of STRS policies, procedures, reports, and a sample of investment transactions;
 - Interviews with 10 trustees and over 25 STRS executives, over 15 outside service providers, and 5 stakeholder groups (retiree, employee, and employer);
 - Self-assessment governance survey with participation by 10 trustees and 11 STRS executives;
 - Use of our proprietary InGov[©] public retirement system peer benchmarking data; and
 - Numerous follow-up interviews and discussions with executives.

Reasonable Reassurance

- This evaluation was a fiduciary review and not a forensic investigation, a comprehensive compliance audit nor an audit of financial statements.
- Our review was intended to provide reasonable, but not absolute, reassurance on matters within scope of the project as addressed in the final report; however, a review of this nature cannot serve as a guarantee regarding past, current or future instances of fraud, malfeasance, compliance or performance.
- Our work product is subject to the accuracy of data and information in the public domain or provided by the client and its agents, including information received in interviews and due diligence activities.
- The scope of the project did not include independent verification or background checks of employees, service providers, third parties or accuracy of such data or information.

Introduction

- There have been some stakeholder criticisms of STRS over the past few years following the reduction in COLA; while this was not directly part of our review, our assessment of the criticisms is:
 - The STRS Board made difficult fiduciary decisions in the best interests of current annuitants and participants who rely on the fund for future retirement benefits.
 - STRS investment performance is in the top 25% compared to peers, and STRS is the top performing Ohio fund over the past 10 years based upon comparisons by ORSC and STRS consultants.
 - STRS staff compensation is consistent with peers and necessary to attract and retain talented staff essential to the success of STRS' internal investment management strategy.
 - STRS has effective policies and processes for closely monitoring and controlling investment costs.
 - Private Equity fee transparency is an industrywide challenge; STRS is participating in the development of new standards as one of a 10-person working group by the CFA Institute commenting on proposed SEC regulatory standards for Private Equity advisors.

Introduction

- Some of the recommendations in this report should address these and other stakeholder criticisms:
 - Improve fee disclosures and transparency, especially private equity (PE) fees (R3.2.4.2-5).
 - Continue to stream Board and committee meetings, and archive recordings on the STRS website (R1.4.2).
 - Make meeting materials publicly available in advance of Board and committee meetings and archive them on the website to improve accessibility (R1.4.3).
 - Improve stakeholder communications through more systematic and inclusive communications planning (R1.9.4-7).

Introduction

A recent Ohio Retired Teachers Association (ORTA) communication to its chapters included several baseless and factually inaccurate comments about this report and Funston Advisory Services (FAS) that we want to address:

ORTA Comment	Response
<p>“Funston is not well regarded in the fiduciary audit business. According to Edward Siedle, Funston provides a report that the person paying the bill wants. STRS paid the bill, so they got the audit report that they paid for.”</p>	<ul style="list-style-type: none">• Siedle and his associates have repeatedly lost to FAS in competitive bids.• The ORSC selected FAS, not STRS.• We have performed numerous fiduciary audits (over 20) and continue to be selected, including for repeat reviews; we have just started two new fiduciary reviews (South Carolina RSIC and District of Columbia Retirement Board).
<p>“Interesting to note is that Funston’s price to do the audit was more than double the price of the other two companies that bid the job to do the audit. The cost was more than 10 times the cost that ORTA paid for the audit by Siedle.”</p>	<ul style="list-style-type: none">• The review conducted by Siedle on behalf of ORTA had no similarity to the scope of the ORSC fiduciary audit.• The ORSC fiduciary audit of STRS was very comprehensive, well structured, and competitively bid.
<p>“Additional evidence that clouds the accuracy of the report is that STRS consultant CEM is closely affiliated with Funston. How can this be independent when the consultant to STRS shares management people with Funston?”</p>	<ul style="list-style-type: none">• FAS has no commercial relationship with CEM, just mutual clients, as we both work with public retirement systems.• We highly respect the work of CEM, as they are considered the “gold standard” for their benchmarking services.• We share no “management people” with CEM.

Overall Findings

- The STRS Board of Trustees has been effectively fulfilling its fiduciary duties (loyalty, prudence, staying informed, diversifying assets, controlling costs, compliance with laws and co-fiduciary duties).
- The STRS Board has the powers or authorities needed to fulfill its fiduciary duties with two exceptions: lack of authority to select outside legal counsel and the custodian (to be discussed later).
- Overall, STRS is operationally excellent with effective operational policies and processes and is a generally well-run, high performing operation.
- STRS' investment performance is in the top quartile of systems in the country according to CEM Benchmarking, and investment operations are excellent.
- Member Services are consistently a top performer while costs are currently lower than the average of STRS' peers.

Overall Findings

- We identified no “red flags.”
- However, as with any organization, improvements can always be made.
- We made over 170 recommendations across the six areas in scope.
- In this presentation we will highlight:
 - The most important conclusions and opportunities for improvement in each area; and
 - Those recommendations that require legislative support.

1. Board Governance and Administration

- Powers delegated by the Board to the Executive Director are consistent with prevailing practices but need improvement and consolidation (R1.2.1).
- The STRS Board use of Committees is ineffective and a lagging practice, and the committee structure could be improved (R1.4.4, R1.4.9-12).
- Communications and transparency need to be improved, including making public materials available in advance of meetings and streaming, recording and publicly archiving meetings (R1.4.2-3, R1.4.6, R1.9.1-2, R1.9.4-7).
- DC Plan oversight by the STRS Board is inadequate and should be significantly improved (R1.10.1-5).

2. Organizational Structure and Staffing

- STRS has a sound operational model
- Staffing and budgets appear reasonable, with STRS headcount declining from 735 to 498 over the past 20 years.
- Member services are high quality, a leader among peers.
- Compensation is consistent with prevailing practice and peers.
- The STRS performance management and training and development programs are leading practice.

3. Investment Policy and Oversight

- Consistent with other large state retirement system peers, STRS manages most of its assets internally.
- The STRS investment program is at an advanced level, with strong performance results versus benchmarks and peers.
- The Board is risk-aware with respect to investments and receives appropriate aggregation reports that identify investment positions.
- STRS was an early adopter of the Global Investment Performance Standards (GIPS[®]), ethical standards for calculating and presenting investment performance that is now considered leading practice.
- Nearly all STRS investment policies and practices are at leading or prevailing levels.
- STRS should, however, develop separate Statements of Investment Objectives and Policy for the DC Plan and the Post-Employment Healthcare Plan (R3.1.3.2-3).

4. Legal Compliance

- The STRS legal team is competent and knowledgeable from a legal operations perspective.
- STRS should improve its approach to managing compliance:
 - Create a Compliance Officer position to develop and manage an enterprise compliance plan and program (R4.2.1).
 - Compliance reporting could be streamlined (R4.3.1, R4.4.1).
 - STRS needs to obtain periodic assurance with respect to IRS compliance (R4.1.1-3).
- STRS should hire an additional attorney to reduce key person risk and ensure adequate succession planning (R4.2.2).
- Either the legislature should allow the STRS Board to hire external legal counsel, or the Attorney General and STRS should formalize a standing process that recognizes STRS' fiduciary obligation to use outside counsel with required expertise (R4.2.4).

5. Risk Management and Controls

- The basics of STRS' Enterprise Risk Management (ERM) approach are prevalent in the industry and public companies; however, they are insufficient for on-going effective holistic risk management.
- Overall, STRS could benefit from a more systematic, comprehensive and coherent and yet simpler approach to risk management (R5.1.1-10).
- STRS should streamline reporting (exception based) to the Board (R5.2.1-10).
- STRS financial accounting and reporting policies and procedures are consistent with prevailing practices.
- Separation of duties is appropriately maintained and is important for completeness, accuracy and reliability.
- The STRS Audit Committee should improve its oversight of the Internal Audit Division and ensure compliance with Institute of Internal Auditor standards (R5.5.2-7).
- STRS has one of the most comprehensive, systematic, and detailed records filing systems we have seen.

6. IT Operations

- For the most part, the controls over the Information Technology function meet and, in some cases, exceed our expectations.
- The size of the IT organization is in line with other systems with assets under management of a magnitude comparable with STRS and extensive internal management.
- The depth of ITS's resources and the cohesion of its management structure are leading towards STRS undertaking two transformative projects simultaneously.
- ITS has documented control-related procedures for all key areas, including project management, information security, IT disaster recovery and business continuity management.

Custody Model

- The Ohio custodian policy, with the Treasurer of State selecting custodial banks, and the requirement for an international sub-custodian, has over time resulted in STRS following an in-house support strategy and minimizing services from the custody banks.
- The relationship and operating environment between STRS and its two custodial banks can be summarized as an “optimization of the suboptimal”.
- Although the Ohio custodial services model is a lagging practice, the Treasurer of State’s office has improved custody bank selection and oversight processes.
- The STRS Board of Trustees should be given authority to select its custodial bank (R3.4.5.1).
- The law in Ohio Revised Code 135.03, “Institutions eligible as public depositories”, and its interpretation, severely restricts the selection of potential custodial banks which can serve STRS; the legislature should this requirement to allow for a single global custodial bank to serve STRS to reduce costs and complexity (R3.4.5.2).

Summary

- Overall, STRS operates effectively, and staff are capable.
- STRS Board oversight appears prudent, but the Board could improve the effectiveness of its oversight.
- STRS leadership has been receptive to our recommendations and has already begun to implement some of them.
- The legislature should consider changes to statutes related to:
 - Hiring of external legal counsel (R4.2.4);
 - Selection and oversight of custodial banks (R3.4.5.1); and
 - Limitations on qualified custodial banks (R3.4.5.2).