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State Treasurer's Office Enters a Transparent and Secure Custody Agreement

> ***Custodian:*** *A custodian is a financial institution that holds customers' securities for safekeeping so as to minimize the risk of their theft or loss. A custodian holds securities and other assets in electronic or physical form. Since they are responsible for the safety of assets and securities that may be worth hundreds of millions or even billions of dollars, custodians generally tend to be large and reputable firms.*
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> *In addition to holding securities for safekeeping, most custodians also offer a variety of other services including account administration, transaction settlements, collection of dividends and interest payments, tax support and foreign exchange. The fees charged by custodians vary, depending on the services desired by the client. Many firms charge custody fees payable quarterly that are based on the aggregate value of the holdings.*[1]

On December 30, 2013, the State Treasurer's Office, as the State's statutory custodian, and the Bank of New York Mellon (the "Bank"), as the State's custodial agent, entered into an updated custody agreement. The agreement enhances transparency, accountability, the security of assets, and will improve access to sophisticated financial tools and services. Pursuant to this agreement, the Bank will hold securities and other assets managed by the State Treasurer's Office ("STO") for the State and participating local governments ("State Funds") and securities and other assets co-held by Public Employees Benefit Authority ("PEBA") and the Budget and Control Board ("BCB") consisting of the State's five defined-benefit retirement plans ("Trust Funds").

State Funds comprise approximately $12.7 billion and include monies invested for the State's General Fund, the State Investment Pool, the Insurance Reserve Fund, the Education Improvement Act, the S.C. Tuition Prepayment Fund, and the Local Government Investment Pool and others. The Trust Funds at September 30, 2013 consisted of approximately $27.6 billion of which approximately 39% was held "in Bank." Based on investment decisions made by the Retirement System Investment Commission ("RSIC"), approximately 61% of Trust Fund assets were held by outside parties, called "out of Bank" assets. RSIC invests the Trust Funds in traditional stocks and bonds but also invests the Trust Funds in complex and illiquid alternative investments, including hedge funds, private equity funds, opportunistic credit funds, strategic partnerships, commodities and real estate. Neither the STO nor the Bank can guarantee the existence, safety, accuracy of reporting or valuations of the out of bank assets.

The value of in-bank and out of bank assets included in the STO's custody agreement is approximately $40.3 billion.

The updated custody agreement is a great improvement on previous versions and will better safeguard State Funds and Trust Funds.

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[1] http://www.investopedia.com/terms/c/custodian.asp

To Increase Transparency, Fees Will Be Invoiced and Paid Directly

Under the updated custody agreement, custodial fees will be paid directly from the applicable Fund. Unlike prior custody agreements, the State Funds and the Trust Funds will now receive a quarterly invoice that identifies the custodial fees charged by the Bank. The invoiced custodial fees for the State Funds, which consists primarily of monies related to general fund activities, will be paid by the State Treasurer's Office from a general fund appropriation, while invoiced custodial fees for the Trust Funds will continue the long-standing precedent of being paid from securities lending revenues earned by the Trust Funds. This method of directly paying custodial fees increases transparency in both the State's general fund and in the State's retirement systems. It also recognizes that the Bank and other custodial banks were no longer willing to waive custodial fees in lieu of taking a larger share of securities lending revenues. Finally, the direct payment of custodial fees prevents the possible overpayment of custody fees, as highlighted by a former RSIC CIO, and therefore places an extra level of accountability on custody fee payments.

State Funds and Trust Funds to Get Larger Share of Securities Lending Revenue

The updated securities lending arrangement will increase the share of securities lending revenues retained by the State Funds and the Trust Funds from 85% to 90%, thereby increasing revenue. In FY2013, RSIC's total earnings (at the 85/15% split) from securities lending for the Trust Funds was approximately $2.195 million, which is more than 6 times the funds needed to pay the Trust Fund's custody fees for the same year.

Bank Accepts More Responsibility for Not-in-Bank Asset Reporting

Under the updated custody agreement, the Bank has committed to performing certain accounting and reporting functions related to retirement system's assets not held by the Bank. These are assets that, pursuant to RSIC investment decisions, are directed to some other party for custody. Because RSIC has caused approximately 61% of the retirements systems' assets to be transferred from the Bank, it is important that the Bank's accounting and reporting obligations include these assets that are not held by the Bank. The prior agreement merely stated that the Bank "may" perform such consolidated accounting and reporting services; now they are mandatory services. Please note, however, that the State Treasurer's Office, nor the Bank, can guarantee the existence, safety, accuracy of reporting, or calculations of the out-of-bank assets.

Confidentiality Provision Added

At the request of RSIC, the updated agreement includes a confidentiality provision that helps to protect information regarding the State's and the retirement systems' investments.

Comprehensive Menu of Ancillary Services Are Made Available to the Trust Funds

Under the updated agreement, the Bank will make available many ancillary services that will assist RSIC in its efforts to improve its control over and monitoring of retirement systems' assets. This favorable pricing is guaranteed for 10 years and therefore will enable the retirement systems to achieve budgetary stability.

Updated Custody Agreement Supports the Global and Diverse Nature of the Trust Funds

The Trust Funds have significantly changed since the custodial agreement with the Bank was renewed in 2007. In 2007, RSIC began to diversify the Trust Funds into alternative investments and into a global portfolio. This diversification made the Trust Fund portfolio more difficult to manage and increased the custodial and related costs incurred by the Trust Fund. In fact, investment decisions made by the RSIC after the issuance of the most recent custody RFP and much of the discussions with the responsive bidders continued to affect the services needed by the Trust Funds and the resulting agreement. For example, the updated agreement recognizes and allows for the RSIC to accomplish its plan to establish global equity and fixed-income accounts in accordance with its FY 2013-2014 Annual Investment Plan by moving assets from commingled accounts held by outside parties to global accounts held by the Bank. Although this investment decision will cause custodial fees paid to the Bank to increase, fees paid to outside parties will decrease. The Trust Fund will have more control over the investments, and the Trust Fund will be more transparent and accountable.

PROCESS

In late 2011, in consultation with the State Procurement Office, the STO issued a request for proposal ("RFP") seeking bids from custodial banks to serve as the State's custodial agent. An advisory panel consisting of employees from the STO, RSIC, and PEBA reviewed the responses to the RFP, met in Columbia with the top bidders, and visited the top bidders in their offices. In May of 2012 the advisory panel and STO's pension consultant recommended that the STO negotiate a custody agreement with the Bank. Based on these recommendations and the settlement agreement negotiations, the Bank was selected to serve as the State's custodial agent.

The panel's 2012 recommendation to continue with the Bank as the State's custodial agent in spite of the then pending litigation with the Bank concerning securities lending activities expressed the advisory panel belief that the Bank was qualified, the pricing was advantageous compared to the Bank's peers, and that the existing relationship with the Bank was positive. The Bank is the world's largest custodial bank with $27.69 trillion in assets under custody and administration.

Pursuant to the settlement of the litigation with the Bank, which was caused by events occurring primarily in 2007 and 2008, the updated custody agreement includes not only the services and fees received through the procurement process but also potential fee concessions that are available to the State and its retirement systems, and additional training valued at $150,000/year.

The term of the 2007 custody agreement was open-ended and had no agreed upon termination date. The updated agreement is for ten years and provides for termination if the business relationship between the State and the Bank is not productive.

In the 2007 custody agreement, the Bank waived its custodial fees in lieu of taking a 15% share of all securities lending revenues earned by the State Funds and the Trust Funds. Under this financial arrangement, the Bank often received annual fees far in excess of annual custodial costs. In 2009, the Chief Investment Officer of RSIC advocated that this financial arrangement change because the Trust Funds appeared to be paying millions of dollars more in fees than if the Trust Funds directly paid their own custodial fees.

In the last few years, securities lending revenues have greatly decreased throughout the industry, in part as lenders like the State Funds and the Trust Funds elected to take less risk. The loss of profit resulted in decreased willingness of custody banks to waive custodial fees. For these reasons, as well as to increase transparency, accountability, security and to ensure that the State was receiving a current and competitive price for custodial and other services, the STO issued the RFP that resulted in this updated agreement.