



THE HONORABLE CURTIS M. LOFTIS, JR.
State Treasurer

To: David Avant, Director of PEBA
Greg Ryberg, Interim COO of RSIC
Marcia Adams, Executive Director of the Budget and Control Board

cc: Les Boles, Director of the State Budget Office

From: Bill Condon, General Counsel for the State Treasurer's Office *Bill*

Date: November 12, 2013

Subject: Payment of SCRS' Custodial Costs under the New Custody Contract

Under a new custodial contract being negotiated, custodial costs directly related to the South Carolina Retirement Systems (SCRS) will need to be paid to the custodial bank. Previously the custodial bank waived its fees for custodial services in exchange for the bank's pro-rata share of securities lending revenues.

The business arrangement under the exiting custodial contract was unsustainable because the custodial bank often earned substantially more than the value of the custodial services performed and because securities lending revenue significantly varied from year to year. Under the existing fee arrangement, the State's custodial bank received securities lending revenues of approximately \$10 million from 2007 through 2010 but only \$725,000 from 2011 through 2013. The \$10 million received by the bank from 2007 to 2010 were far in excess of the fees that the bank otherwise would have earned for custodial services. In addition, the securities lending revenues from 2007 to 2013 demonstrate that securities lending revenues significantly vary from year to year. These facts made this business arrangement unsustainable. Although correcting an unsustainable business arrangement is necessary by SCRS directly paying custodial fees and receiving a greater share of securities lending revenues, the direct payment of custodial fees raises some issues which the fiduciaries of SCRS need to address and which are presented in this memorandum.

Accordingly the purpose of this memorandum is to document and seek agreement among the fiduciaries of SCRS about the nature of SCRS' custodial costs, whether SCRS' custodial costs need to be budgeted, and how SCRS' custodial costs will be paid. These issues have been the topic of a couple of meetings of staff of various fiduciaries of SCRS and were recently discussed at a Retirement System Investment Commission (RSIC) meeting.

Based on these discussions, it seemed proper to document and analyze the issues and to propose a course of action. Accordingly, the State Treasurer's Office (STO), as statutory custodian, has prepared this document for review by the appropriate persons in the four State agencies that are fiduciaries to SCRS.

In summary, the State Treasurer's Office seeks the agreement among the fiduciaries to SCRS regarding how custodial costs will be paid and specifically seeks agreement among the fiduciaries that:

1. SCRS' custodial costs are expenses of the trust and should be paid directly out of the trust, and
2. As expenses of the trust and for services which are an integral part of the overall management of the trust, SCRS' custodial costs do not need to be budgeted and can be paid directly from the trust.

FACTS

SCRS includes five defined benefit pension plans. SCRS has several fiduciaries: the Budget & Control Board (B&CB), the Public Employee Benefit Authority (PEBA), RSIC, and STO. B&CB and PEBA are co-trustees of SCRS. S.C. Code Ann. § 9-1-1310(A). RSIC has the sole authority to invest and manage SCRS' assets. S.C. Code Ann. § 9-6-20(A). STO is the statutory custodial of SCRS' funds. S.C. Code Ann. § 9-1-1320. Each of these entities is a co-fiduciary with each other entity.

SCRS was created many years ago, and STO has been the statutory custodian for many years. For a long time, SCRS invested only in publically traded fixed income securities. In about 2000, SCRS was allowed to invest in domestic equity securities. As statutory custodian, STO engaged a custodial bank to serve as the custodian in order to hold the SCRS' securities, collect income, make necessary distributions, and perform other functions for the benefit of the trust.¹

In about 2005, RSIC was created and was granted the authority to invest in a wide range of assets across the globe. As RSIC diversified SCRS' portfolio, custodial activities increased (e.g., opening accounts in securities markets throughout the world). More recently, RSIC has decided to bring some of the investments that had been sent to outside third-party managers back to the State's custodial bank, which will also increase the volume of custodial activities by the custodial bank.

In 2007, the then State Treasurer, as statutory custodial of SCRS' funds, negotiated with the custodial bank a contract in which the bank waived its fees related to custodial services for SCRS. In exchange, the bank kept 15% of the revenues that it generated from engaging in securities lending with SCRS's assets. For several years the bank was happy because its share of the securities lending revenues

¹ Note that the same custodial bank performs similar services for the State's non-SCRS funds. A large portion of these non-SCRS funds are related to general funds or other budgeted funds of the State, so the non-SCRS custodial costs are part of STO's budget for FY 2014. This memorandum is about only SCRS' funds and about custodial costs related to SCRS' funds.

exceeded the fees that it otherwise would have charged SCRS for custodial services. In recent years, securities lending revenue has been severely reduced, so the bank's pro-rata share of securities lending revenues has significantly decreased. Accordingly, the custodial bank no longer wants to continue the existing contractual arrangement regarding SCRS' funds. In fact, prior to the issuance of STO's RFP for custodial services in late 2011, the existing custodial bank had indicated that it needed to change this arrangement so that SCRS would directly pay fees for its custodial services.

Via proper procurement channels, STO has now selected a custodial bank (the existing custodial bank is to be retained) and is nearing the time at which a new custodial contract will be executed. SCRS's custodial costs will be a flat annual fee of \$260,000 plus variable transaction and asset-based fees related to global assets (which may approximate \$2 million per year).

Representatives from STO, RSIC, and PEBA have met and discussed the changing investment strategy of RSIC which will increase SCRS' custodial costs and the manner in which the custodial costs shall be paid.

In addition, at the September 26, 2013 RSIC meeting, how custodial costs would be paid under the new custody contract was discussed in open session. Since David Avant of PEBA and Curtis Loftis, the State Treasurer, are members of RSIC, the fiduciaries of SCRS were represented in some manner during this discussion. There was general consensus at this meeting that SCRS' custodial costs were expenses of the trust; however, there was less certainty about whether SCRS' custodial costs should be on one of the agency's budgets or whether they should be paid directly out of the trust. CIO Hershel Harper raised the concern that some of the custodial costs are variable depending on the number of transactions and the value of the assets and that it would be difficult to budget for these variable expenses (which may approach \$2 million per year). As the discussion concluded, there was agreement that the fiduciaries needed to come to an agreement on the payment of SCRS' custodial costs. As stated above, the purpose of this memorandum is to obtain that agreement.

LAW

"Money shall be drawn from the treasury of the State or the treasury of any of its political subdivisions only in pursuance of appropriations made by law." S.C. Const. Art. X, § 8. This constitutional provision was codified in the following statute: "It shall be unlawful for any monies to be expended for any purpose or activity except that for which it is specifically appropriated" S.C. Code Ann. § 11-9-10.

Article X, Section 8 of the S.C. Constitution, which prohibits disbursement without legislative appropriation, applies only to funds of the public, not to another's or trust funds. See *Foster v. Taylor*, 210 S.C. 324, 332, 42 S.E.2d 531, 535 (S.C. 1947) (emphasis added). Title 9 of the S.C. Code of Laws states that SCRS' funds are not funds of the State but are funds held in trust. S.C. Code Ann. § 9-1-1310(C). Additionally, "[a]ll assets of a retirement system are held in trust," and PEBA "shall hold the assets of the retirement systems in a group trust under Section 401(a)(24) of the Internal Revenue Code." S.C. Code Ann. §§ 9-16-20(A), (C).

The administrative costs of the SCRS “must be funded from the interest earnings of [SCRS].” S.C. Code Ann. § 9-1-310.

ANALYSIS

SCRS Is a Trust

SCRS (as it is defined above includes all five defined-benefit pension plans of the State of S.C.) is clearly a trust, and its funds and assets are not funds and assets of the State of South Carolina. This is evident from the above-referenced law. In addition, Section 9-16-20(C) states that the assets of SCRS are held in a group trust under IRS § 401(a)(24). This subsection of the Internal Revenue Code addresses a group trust created as part of a pension plan for a governmental unit. As additional support, the audited financial statements of SCRS for FY 2013 state in several places that SCRS is a trust and reiterate the language of Sections 9-1-1310 and 9-16-20 that the funds and assets of SCRS are not funds of the State but are held in trust.

Custodial Costs Are an Expense of the Trust

Since SCRS is a trust, its custodial costs should be an expense of and paid by the trust. As stated above and as documented in the transcript of the September 26, 2013 RSIC meeting, there is general consensus among the members of the RSIC and RSIC’s senior staff that the trust should pay for any custodial costs related to trust assets. This consensus is bolstered by the following:

1. Custodial costs are direct costs of holding and managing the funds and assets of SCRS. Custodial costs include costs for the custodial bank to hold the assets; to collect income (interest and dividends); to transfer funds to not-in-bank investments; to receive distributions from not-in-bank investments; to make payments to receive, open, and manage accounts in foreign markets to facilitate SCRS’ investments in those markets; etc. Accordingly, those who manage the assets of the trust (i.e., staff of RSIC and third-party investment managers) have frequent communications with the State’s custodial bank. Additionally, the State’s custodial bank provides accounting data to PEBA, which prepares SCRS’ annual financial statements, and reporting and information resources to the various fiduciary entities, certain contractors and advisers engaged by a fiduciary, and third-party investment managers engaged by RSIC.
2. Treating custodial costs as an expense of the trust is consistent with treating investment management fees, a cost which is accounted for in the same manner as custodial costs, as an expense of the trust. Generally accepted accounting principles (GAAP) dictate that custodial costs are to be reported, along with investment management fees, as investment expense – a component of net investment income – on SCRS’ Statement of Changes in Plan Net Assets. In paragraph 22 of Statement No. 67 of the Governmental Accounting Standards Board, Financial Reporting for Pension Plans, GASB says that net investment income on the statement of changes in fiduciary net position includes investment income and “investment expense, including investment management and custodial fees and all other significant investment-related costs.”

Therefore, since investment management fees and expenses, which totaled more than \$400,000,000 in FY 2013 are treated as an expense of the trust, custodial expenses which are currently estimated to range from only \$1,500,000 to \$2,250,000 per year should also be treated as an expense of the trust.

3. Custodial expenses have a direct relationship to the investment decisions that are made for SCRS, so it is reasonable that the costs should offset the expected gains that will be achieved from these investment decisions. For example:
 - a. It is reasonable to believe that a trust with a global portfolio will incur more custodial costs than a trust with a domestic portfolio. For example, having a global portfolio requires the custodial bank to engage and monitor subcustodians in each foreign market in which SCRS directly invests.
 - b. The FY 2014 decision to invest 40% of SCRS' asset in global equities and 75% of that amount in passive, benchmark-driven exposures to global equities will cause an increase in equity assets being held by the State's custodial bank. Under the new custody contract, this investment strategy will cause custodial costs to increase significantly (although investment management fees may decrease). CIO Harper stated that the variable portion of the custodial costs will fluctuate with market movements and managers' decisions on which markets to invest.

Custodial Costs Should Be Paid Directly from the Trust

As an expense of the trust, the question is now whether the custodial costs should be on the operating budget of one of the fiduciaries (and funded by a transfer of trust funds from the trust to the budgeting agency – similar to how RSIC's and some of PEBA's operating expenses are currently funded) or whether the custodial costs should not be budgeted but should be paid directly by the trust (as investment management fees are paid).

As stated above, the S.C. Constitution requires that money may be drawn from the State's treasury "only in pursuance of appropriations made by law." S.C. Const. Art. X, § 8. The General Assembly codified this constitutional provision in Section 11-9-10, which says, "It shall be unlawful for any monies to be expensed for any purpose or activity except that for which it is specifically appropriated" An appropriation is a legislative act of setting aside a sum of money for a public purpose. BLACK'S LAW DICTIONARY 98 (7th ed. 1999).

If these constitutional and statutory provisions applied to SCRS, then it would appear that the General Assembly annually would have to set aside in its appropriations act a sum or source of money from which SCRS' investment management fees and custodial costs would be paid. However, the General Assembly has not made an appropriation for these costs in the past. Although, as explained above, SCRS has not directly been paying custodial costs (because the custodial bank has been taking its 15% share of the revenues from securities lending activities that in many years far exceeded the custodial fees that the bank would have otherwise earned), SCRS has been incurring and paying significant investment

management fees and expenses which have not been appropriated. Investment management fees have been taken directly from the trust.

It appears proper to pay investment management fees, and now custodial costs, directly from the trust without an annual appropriation because Article X, Section 8 of the S.C. Constitution and Section 11-9-10 do not apply to SCRS. This is because of the following:

1. The above-stated constitutional provision says that money “drawn from the State’s treasury” must be done in accordance with an appropriation. Because monies in the trust are not State funds but are funds held in trust, the funds used to pay for investment management fees and custodial costs are NOT drawn from the State’s treasury making the constitutional provision not applicable to SCRS.
2. According to a S.C. Supreme Court decision in *Foster v. Taylor*, 210 S.C. 324, 332, 42 S.E.2d 531, 535 (S.C. 1947), Article X, Section 8 of the S.C. Constitution does not apply to trust funds.

In addition to the above, I spoke with Les Boles, Director of the State Budget Office, who indicated that custodial costs could be paid directly from SCRS without an annual appropriation because custodial costs appear to be part of investment expense and part of the overall management of the trust.² Prior to giving this opinion, I explained to Mr. Boles the nature of custodial costs and that GAAP requires that custodial costs be accounted for the same as the investment management fees, which are paid directly from the trust without an annual appropriation. Mr. Boles added that custodial costs must be accounted for in accordance with GAAP and that the State incurs a lot of costs that are not appropriated, so transparency is needed.

Budgeting and Transparency

As stated above, STO expects that the new custody contract will be ready to be executed soon. Once executed, SCRS will incur custodial costs in FY 2014, although no State agency has SCRS’ custodial costs budgeted for FY 2014. As documented above, this is acceptable because SCRS’ custodial costs may be paid directly from the trust without an annual appropriation.

However, at the September 26, 2013 RSIC meeting, there was some discussion that custodial costs should be on an agency’s budget for transparency purposes, and transparency was an issue that Mr. Boles mentioned. Transparency through budgeting for custodial costs may however be difficult. CIO Harper noted that it would be difficult to budget SCRS’ custodial costs because of the variable nature of a large portion of those costs.

² Please note that I spoke to Mr. Boles before this memorandum was drafted and that Mr. Boles’ opinion was based on the discussion that he and I had. I believe that our discussion was consistent with the facts and law expressed in this memorandum; however, I am sending a copy of this memorandum to Mr. Boles so that he has the opportunity to revise his opinion, if necessary, based on this memorandum.

This issue is raised here to more fully document the issues of concern to SCRS' fiduciaries. It appears that the fiduciaries may have some time to address the issue of whether SCRS' custodial costs should be budgeted in future years, while FY 2014 custodial costs – although not budgeted – may still be properly paid directly from the trust.

The fiduciaries may decide that transparency may be achieved sufficiently through means other than budgeting for custodial costs. For example, custodial costs could be disclosed in the notes to SCRS' audited financial statements. Additionally, STO and/or other fiduciaries to SCRS may post the invoices for SCRS' custodial services on the fiduciary agency's website. Finally, this memorandum and related discussions certainly have created transparency about the issue and the course of action being proposed.

CONCLUSION

Based on the above, SCRS is a trust, and SCRS' custodial expenses are expenses of the trust. The custodial costs may also be paid directly from the trust without an annual appropriation by the General Assembly.³

STO asks that PEBA, RSIC, and the B&CB send to STO a written confirmation regarding that agency's agreement with the conclusion that custodial costs of SCRS may be paid directly from the trust. If an agency has questions or does not agree with the proposed conclusion, please let us know that too.

³ As the statutory custodian, STO expects that the new custodial contract will direct the custodial bank to send the quarterly detailed invoice for SCRS' custody costs to STO and that it will likely need to work with RSIC and PEBA to validate, approve, and authorize payment of each invoice. Because of the variable nature of some of custody costs, STO may need RSIC to review and approve the quarterly invoice before it is paid, and STO may have to work with RSIC to formalize this review process. STO may also need to work PEBA to ensure the payment is properly and timely made from the trust. See S.C. Code Ann. § 9-1-1320 (saying "[a]ll payments from [SCRS'] funds shall be made by [the State Treasurer] only upon vouchers signed by two persons designated by [PEBA]").