Department of the Treasury
Division of Investment

July 1, 1999 to April 30, 2001

Richard L. Fair
State Auditor
The Honorable Donald T. DiFrancesco
Acting Governor of New Jersey

The Honorable Donald T. DiFrancesco
President of the Senate

The Honorable Jack Collins
Speaker of the General Assembly

Mr. Albert Porroni
Executive Director
Office of Legislative Services

Enclosed is our report on the audit of the Department of the Treasury, Division of Investment for the period July 1, 1999 to April 30, 2001.

If you would like a personal briefing, please call me at (609) 292-3700.

Thomas R. Meseroll
Quality Assurance Administrator

June 5, 2001
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Scope
We have completed an audit of the Department of the Treasury, Division of Investment for the period July 1, 1999 to April 30, 2001. Total administrative costs of the division during the 22 month period were $10 million. The prime responsibility of the division is the centralized purchase, sale, or exchange of securities of the state’s diverse funds. The State Investment Council is responsible for setting the policies by which the division manages the state’s portfolio. The market value of the assets under management on April 30, 2001 was approximately $86 billion.

Objectives
The objective of our audit was to determine whether the division was properly executing its fiduciary responsibility in its portfolio management in that the division properly structured, monitored, and analyzed their investment portfolios and activities. An additional objective was to determine whether the division controlled investment expenses. We also tested for resolution of significant conditions noted in our prior report.

This audit was conducted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section 1, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

Methodology
Our audit was conducted in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

In preparation for our testing, we studied legislation, administrative code, circular letters promulgated by the State Comptroller, and policies of the division. Provisions we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our samples of financial transactions. We also
reviewed the division’s annual report which contains their annual independent audit report, reviewed investment performance, and interviewed agency personnel to obtain an understanding of the programs and the internal controls.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions about the validity of transactions as well as internal control and compliance attributes. Sample populations were sorted and transactions were judgmentally selected for testing.

To ascertain the status of findings included in our prior report, we identified corrective action, if any, taken by the agency and walked through the system to determine if the corrective action was effective.

**Conclusions**

We found the division was properly executing its fiduciary responsibility in its portfolio management. The division also properly controlled investment expenses. In making this determination, we noted a procedural issue and cost/revenue enhancements meriting management’s attention. We also found the agency has resolved the significant issues noted in our prior report, except for the matter related to the custody of investment funds. This issue has been updated and restated in our current report.

The following graphs illustrate how well the division is fulfilling its responsibilities.
This chart shows the overall investment performance of New Jersey pension funds in relationship to other states. The median state fund and public funds index returns were provided by an independent survey of participating public pension funds.

This graph shows the investment performance of the domestic equity portfolio of Common Pension Fund A, which totaled $32.5 billion at March 31, 2001, in relation to the benchmark Standard and Poor’s 500 Index. (FY 2001 is unaudited).
This graph shows the investment performance of the fixed income portfolio of Common Pension Fund B, which totaled $19.6 billion at March 31, 2001, in relation to the benchmark Lehman Brothers Aggregate Index. (FY 2001 is unaudited).

This graph shows the investment performance of the foreign equity performance of Common Pension Fund D, which totaled $11.8 billion at March 31, 2001, in relation to the benchmark EAFE (Europe and Australasia, Far East) Index. (FY 2001 is unaudited).
The division can enhance revenues by $20 million - $40 million if the bank custody law is changed.

**Bank Custody**

N.J.S.A. 52:18A-8.1 requires the State Treasurer to utilize only national banks with a principal office in New Jersey as custodians for the State’s domestic and foreign securities. All the banks that the division previously contracted with for custodial services have merged or been acquired by out-of-state banks. The statute limits the ability of the State Treasurer to competitively bid for suitable custodial services and therefore to potentially reduce expenses. The Division of Investment incurred $4.5 million in custodial fees in calendar year 2000.

Additionally, the statute prevents the Division of Investment from taking advantage of potential opportunities that are common industry practice. For example, the division cannot lend its securities because physical custody would, in many cases, have to transfer to an out-of-state sub-custodian. The statute is silent regarding the use of out-of-state sub-custodians and has been interpreted by the division’s legal counsel as not being permitted by the statute. Even with a revision in the law, any investment areas not currently permitted by the administrative code would have to be approved in advance by the State Investment Council. A recent study by an industry specialist has estimated that New Jersey’s portfolio could generate an additional $20 million - $40 million per year through securities lending.

**Recommendation**

We recommend the division continue its efforts to have the bank custody law revised.

**Auditee’s Response**

The Division has supported legislation which would alleviate the limitation bank custody law imposes. The current law does not permit the use of subcustodian banks and severely restricts the ability of the State Treasurer to competitively bid for suitable custodian services. Assembly Bill A-1722 (Lance) would remedy both of these limitations. The ability to utilize subcustodian banks would permit
the Division to consider implementing securities lending, which could provide an estimated $20-$40 million annually in additional income.

The Division concurs with the State Auditor recommendation that a revision in the bank custody law is necessary and could provide additional income and reduced bank custody costs.

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**Council Regulations**

Time limits are needed for certain investment decisions.

The State Investment Council determines which securities are suitable for the division in accordance with their fiduciary responsibility. In order to provide better control, N.J.A.C. 17:16-41.1 and N.J.A.C. 17:16-44.1 permit the division to own stock in domestic and foreign companies from a list approved by the Council. We noted that the state owned the stocks of 46 companies, with a market value of more than $130 million as of January 31, 2001, that were not on the approved list. These securities were added to the state’s portfolio as a result of mergers and spin-offs involving previously owned companies on the approved list. Although it has been the division’s practice to request these securities be added to the approved list or to eliminate them from the portfolio, there is no time limit specified to guide these decisions. The absence of a time requirement increases the risk of owning unwanted securities.

**Recommendation**

We recommend the State Investment Council consider setting a 180 day time limit for the division to decide whether to hold onto stocks acquired through mergers and spin-offs.

**Auditee’s Response**

During the course of the year and as a result of holding over 1,000 common stocks, the Division has been the recipient of many corporate restructurings or “spin-offs” of new companies. These companies are sometimes held in the portfolio, although they are not part of the authorized list of permissible investments.
previously approved by the State Investment Council. The state auditors identified 46 such companies having a market value of $130 million. The division agrees that a specific time limit be established by the Council to decide whether or not to continue to hold these investments. During this time period, the company may be added to the authorized list of permissible investments, however, if it is not, the investment would be sold before the end of the permitted holding period. We are in the process of drafting an internal regulation that will be proposed to the Council as a way of formalizing this requirement.

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**Soft Dollars**

The division paid commissions of approximately $33 million during fiscal year 2000 for securities transactions. The division frequently enters into soft dollar arrangements with its brokers. Under these arrangements, the division purchases trade execution and other services related to investment management as a package. We noted the division is also procuring research related services and financial data with state appropriations. These services are available through brokers and can be paid with soft dollar commissions. We identified $382,000 in research related services and financial data that can instead be paid using soft dollar arrangements. These services would be allowable under section 28(e) of the Securities Exchange Act of 1934 which defines allowable uses of soft dollars.

**Recommendation**

We recommend the division use soft dollar agreements to pay for research services now being paid through state appropriations.

**Auditee’s Response**

The Division generates stock commission “credits” as a result of its investment responsibilities. These commissions provide the investment staff with investment research reports, industry and economic analyses. Since commissions are variable based
upon cash flows and transactions activity, it is important that in the event that commissions decline, critical investment tools are available through the appropriated budget for the Division. The Division relies upon budgeted appropriations for a small amount ($382,000) of critical applications such as quote terminals and a financial database. The Division believes these costs should remain in the appropriated budget due to their critical nature. The State Investment Council concurs with this judgement.