New Jersey State Legislature
Office of Legislative Services
Office of the State Auditor

Department of the Treasury
Division of Investment

July 1, 2003 to July 31, 2005

Richard L. Fair
State Auditor
The Honorable Richard J. Codey  
Acting Governor of New Jersey

The Honorable Richard J. Codey  
President of the Senate

The Honorable Albie Sires  
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 of July 1, 2003 to July 31, 2005. If you would like a personal briefing, please call me at (609) 292-3700.

Richard L. Fair  
State Auditor  
October 18, 2005
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Department of the Treasury
Division of Investment

Scope

We have completed an audit of the Department of the Treasury, Division of Investment for the period July 1, 2003 to July 31, 2005. Average administrative costs of the division were $6.9 million a year. 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 July 31, 2005 was approximately $83.2 billion.

On July 15 and August 2, 2005 the division entered into agreements committing the state to invest $75 million and $200 million, respectively, of state pension funds to private equity partnerships managed by third parties. These agreements were not included in the scope of this audit.

Objectives

The objectives of our audit were to determine whether the financial transactions were related to the agency’s programs, were reasonable, and were recorded properly in the accounting systems. We also tested for resolution of significant conditions noted in our prior report dated June 5, 2001.

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 agency. Provisions that we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our samples of financial transactions. We also read the budget message, reviewed financial trends, 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. Some 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 that the financial transactions included in our testing were related to the agency's programs, were reasonable, and were recorded properly in the accounting systems. We also found the agency has resolved the significant issues noted in our prior report, except for the matter related to soft dollars. This issue has been updated in our current report.
Soft Dollars

Appropriated expenditures can be reduced by optimizing the use of soft dollars.

The division paid commissions totaling $33 million during fiscal year 2005 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 research as a package. However, the division also procures research services and financial data with state appropriations. These services are available for payment through brokers and can be paid with soft dollar commissions. We identified expenditures for research related services totaling $425,000 and $480,000 for fiscal years 2004 and 2005, respectively, that could have been 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 arrangements instead of state appropriations to pay for research related services.
October 5, 2005

Mr. Thomas R. Meseroll  
Office of the State Auditor  
125 South Warren Street  
P.O. Box 067  
Trenton, N.J. 08625

Dear Mr. Meseroll:

This is in response to the audit report of the Department of the Treasury, Division of Investment.

The Division has already moved $94,000 of the services identified above to a soft-dollar arrangement for fiscal 2006.

The $480,000 identified in the audit represents the actual cost of the research services and any savings realized through a soft dollar arrangement would only be a fraction of this amount. Further, soft dollar arrangements are only a viable option to the extent that the Division generates enough trading activity to pay for all of its investment research and services and the Division obtains “best execution” on those trades. In addition, soft dollar arrangements require a fair amount of internal administrative effort.

On September 21, 2005 the SEC issued new guidance on soft-dollar restrictions. The guidance is open for a 30-day public comment period and the SEC intends to propose a new regulation shortly afterward. We will review our research services in conjunction with the new guidelines and state procurement policies and make appropriate adjustments after consideration of all of the factors discussed above.

Sincerely,

William G. Clark  
Director

CC: Mr. John E. McCormac, Treasurer