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

Department of the Treasury
Division of Investment

July 1, 1995 to June 30, 1997

Richard L. Fair
State Auditor
Enclosed is our report on the audit of the Department of the Treasury, Division of Investment for the period July 1, 1995 to June 30, 1997.

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

Peter M. Guilfoyle
Assistant State Auditor
July 31, 1997
# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope</td>
<td>1</td>
</tr>
<tr>
<td>Objectives</td>
<td>1</td>
</tr>
<tr>
<td>Methodology</td>
<td>1</td>
</tr>
<tr>
<td>Conclusions</td>
<td>2</td>
</tr>
<tr>
<td>Findings and Recommendations</td>
<td></td>
</tr>
<tr>
<td>Use and Control of Soft Dollars</td>
<td>4</td>
</tr>
<tr>
<td>Policies and Procedures</td>
<td>8</td>
</tr>
<tr>
<td>Execution</td>
<td>10</td>
</tr>
<tr>
<td>Human Resources</td>
<td>12</td>
</tr>
<tr>
<td>Custodian Banks</td>
<td>13</td>
</tr>
</tbody>
</table>
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, 1995 to June 30, 1997. Total administrative costs of the division during the 24 month audit period were approximately $8.8 million. The prime responsibility of the division is the centralized purchase, sale, or exchange of securities for the state’s diverse funds. The Investment Council is responsible with setting the policies by which the division manages the state’s portfolio. The market value of the assets under management on June 30, 1997 was approximately $65.9 billion.

Objectives

The objectives of our audit were to determine whether the division is properly executing its fiduciary responsibility in its portfolio management. In addition, our objectives were to determine whether the division properly structures, monitors, and analyzes their investment portfolios and activities. Our final objective was to determine whether the division controls investment risk and expense, and properly measures and evaluates investment performance.

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. We reviewed the investment program and practices of the division which is under the jurisdiction of the State Investment Council. Provisions that we considered significant were documented and compliance
with those requirements was verified by interview and 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 control structure.

Conclusions

We found that the division is properly executing its fiduciary responsibility in its portfolio management. In addition, the division properly structures, monitors, and analyzes their investment portfolios and activities. The division also properly controls investment risk and expense, and measures and evaluates investment performance. In making this determination, we noted certain internal control weaknesses and matters of compliance with laws and regulations meriting management’s attention. The following graphs illustrate how well the division is fulfilling its responsibilities.
The overall investment performance of the division in relationship to that of other states (NASIO is the National Association of State Investment Officers).


**Auditee's Response**

The Division was pleased the Office of the State Auditors' report concluded that it found that the Division's investment policies, investment structure, risk controls, performance measurement, and analyses of the $65.9 billion portfolio were proper and effective.
The division should institute the internal controls necessary to properly account for and report the value of services received for their soft dollar commissions.

Use and Control of Soft Dollars

The division paid commissions of approximately $25 million during fiscal year 1997 for securities transactions. The division frequently enters into what are commonly called soft dollar arrangements with its brokers. Under soft dollar arrangements, the division purchases trade execution and other services related to investment management as a package. The rate at which the division negotiates and receives soft dollar services for each commission dollar is known as the conversion ratio. The division’s conversion ratio is approximately 1.6 to 1 which means that for every $1.60 in commissions paid to brokerage firms, the division receives $1 in investment related services. During our audit we noted the following weaknesses in the reporting and accounting of soft dollars which should be corrected to strengthen internal controls:

C There is no disclosure in the division’s annual report about the amount and types of soft dollar arrangements. Disclosure of the soft dollar arrangements is required pursuant to the Securities and Exchange Commission regulations which are voluntarily complied with by the division. During fiscal year 1997, the division entered into soft dollar arrangements totaling $10.2 million resulting in the division receiving $6.4 million in investment related services from the brokerage firms or soft dollar vendors.

C The division prepaid their soft dollar commission allocations by approximately $1 million in Fiscal Year 1997 (soft dollar credits had not been applied to acquire services or products). The prepaid commission amounts were not formally approved prior to the liability being established.
C When the division uses investment related services of brokerage firms as part of the soft dollar arrangements, copies of the fixed cost bills are prepared and sent to the division. Most of the vendor bills are not maintained by the individual responsible for accounting for the soft dollar arrangements. Without such documentation, the accountability for the research related services is weakened.

C The individual requesting the product or service does not review and approve the third party fixed cost bills before they are recorded and authorized for payment. A formal process for using and approving requisitions is also not in use to support the corresponding commission allocation. The applicable research analyst or portfolio manager allocates (subject to review and approval) an estimated amount of commissions necessary to cover the cost of the soft dollar service.

**Recommendation**

We recommend that the division improve the internal controls and reporting relating to their soft dollar program by initiating the following procedures:

C There should be disclosure in the division’s annual report about the amount and types of soft dollar arrangements;

C The prepaid soft dollar commission amounts that were paid to brokers in excess of the original allocation should be formally approved in advance;

C Copies of the fixed cost third party bills of the soft dollar vendors should be maintained to document that the agreed upon goods or services were received as compensation for the soft dollar commissions; and
A formal process for using and approving requisitions should be instituted as part of the soft dollar program to set aside soft dollar commission allocations.

**Auditee's Response**

The Division, through its monthly reports, discloses every commission paid on every transaction. In addition, the Division, as part of its annual audit by Coopers & Lybrand, publishes thirteen bound reports, one of which is the Transactions and Commissions Volume Report which shows the aggregate of all commissions paid to each firm during the year. These are part of Coopers & Lybrand's presentation to the Council each September. In the past, the Division has excluded these reports from the Division's annual report due to space considerations, but always notes that they are available upon request. The commission report is sent to Council members, the State Library and other interested parties. The Division's monthly report of securities transactions has a mailing list of approximately 200 copies. The Division will provide a summary of its commissions in the Council's Annual Report.

Supplemental soft dollar fees

The Division's procedure for changing soft dollar fees during the year, requires that the individual requesting a change in services prepare a memo to the Director identifying the change in service for the Director's approval. Because of the nature of changing levels of service, compliance with these procedures has been generally followed but compliance has not been 100 percent. In the event unauthorized services were engaged, the Trading Officer or the Director could refuse to authorize payment. This has never occurred. The Division has already tightened these procedures and will continue to monitor these
changes. The Division will provide for formal approval of all supplemental fees, which in the past have represented prepayments for services we have used for many years.

C Soft dollar bills and records

The vast majority of the $25 million in commissions generated last year were not for "fixed cost bills," but roughly 12 percent of commissions, or $3 million, were used to pay for services such as performance measurement, financial databases and quote terminals, as well as more specialized research products. This 12 percent of the total commission budget is for research services which have a fixed annual subscription cost. Either the annual amount is paid or the service is discontinued. The remainder of the commissions consist of research, which generally operates on our best efforts or good faith evaluation of the research product, which is evaluated by the Division semiannually.

In the percentage of cases where bills are involved, as indicated above, it has been the responsibility of the individual, the vendor and the Trading Officer to maintain accurate records. This often places a burden on the trading desk, especially when trying to reconcile differences, price changes, or changing levels of service. The requesting individual should be responsible for maintaining accurate records, or the Internal Auditing Unit could undertake coordinating these bills in cooperation with the individual and trading desk. A formalization of this procedure would require the Division to hire an additional accountant to monitor commission payments.

C Formal requisitions for a change in commissions

These research bills are complicated by price changes, upgrades, multiple users, elimination of parts of services, exchange fees, new mandates, changing
technology, inflexible State budgets and time-sharing systems, where costs vary based upon usage. A new format for requesting changes in research services will be developed for the Division, jointly by the Trading and Research Officers. The Division will also instruct the internal audit unit to reconcile billable items with the trading desk, vendor and individual sponsor(s). In the past, this reconciliation process gravitated to the trading desk, which is responsible for many other important activities. While these changes are beneficial, the Division believes all past commission dollar usage has been effectively allocated.

Policies and Procedures

The division properly segregates the review, authorization, trading, and accounting functions relating to security transactions. The internal controls are also reviewed as part of the division’s annual financial audit. However, the functions and processes are not recorded in a policies and procedures manual. A policies and procedures manual is necessary to document and communicate the accepted internal controls of the division.

The division is subject to both the Department of the Treasury’s Code of Ethics and its own ethics code. The division requires each employee to complete a semi-annual report listing personal investment transactions and the related broker. However, there are no employee reporting requirements in effect to assure compliance with the department’s provisions relating to the purchase of securities from an underwriting syndicate. As a result, employees are not required to report securities purchased as initial public offerings. Although the department’s code of ethics requires employees to disclose any spousal association and/or employment with any financial
entity, there are no reporting procedures in effect to monitor compliance.

**Recommendation**

We recommend that the division formalize their procedures relating to securities transactions by recording them in a policies and procedures manual. We also recommend that the division periodically review and update their ethical standards reporting requirements in order to be in compliance with all provisions of the department’s ethical standards.

**Auditee’s Response**

C  Procedural Manuals

The Division's investment policies are well documented by statute and Council regulation. In addition, the Division has internal guidelines and procedures that are either written or implemented orally through the weekly investment meetings. By way of example, during calendar 1996, the Director or Deputy Director signed or initialed 11,587 individual securities transactions folders. The Division's internal policies and procedures regarding securities transactions could be further developed to establish a complete written record, and the control example above could be relaxed. The Division will develop written policies and procedures for securities transactions in addition to those covered by the Council regulations and State law.

C  Report on Spousal Employment

The Employees Semiannual Report on Securities Transactions form, which is completed by all employees and reported to the Council can be modified as suggested by the State Auditor's Office. This would include the disclosure of any spousal employment at financial institutions and any purchases of initial public offerings by employees. All Division employees have completed the Treasury Department's outside employment form which includes "immediate family members," and are in compliance with Trea-
The Division will modify the Employee's Semiannual Report on Securities Transactions to include any spousal employment and transactions in new issues for the next (December, 1997) reporting period.

\[ \frac{3}{4} \]

### Execution

The effectiveness of the brokers executing trades for the division is closely monitored by the trading unit of the division. In addition, the execution prices are also monitored by the research analysts and portfolio managers. However, there has not been an independent review authorized by the Investment Council of the effectiveness of the execution since the review conducted for the period January 2, 1990 to March 31, 1990. A periodic independent review conducted by experts is necessary to evaluate the effectiveness of the division's execution. Proper execution can save the division millions of dollars over years.

**Recommendation**

We recommend that the Investment Council and division solicit bids by independent consultants to conduct a review of its execution effectiveness.

**Auditee's Response**

C Stock Transaction Measurement

The Division monitors its transaction on a weekly basis and from time to time has used outside consultants to measure the quality of its equity transactions.
Transaction measurement services are most often used by plan sponsors who use outside managers. Plan sponsors monitor managers' transactions and also ensure that managers are abiding by their investment mandate, for which he or she was hired. In the past, the Council has not felt a need for regular transaction measurement reports, since their value is sometimes informative but rarely conclusive. The process can be moderately expensive, at about $30,000 to $60,000 annually. In fiscal year 1997, the Division had approximately 86,000 domestic equity transactions. Nevertheless, the Division has from time to time engaged outside consultants to evaluate transactions and is willing to undertake the effort on a more regular basis, if the Council is interested in having this material available for review. In the past, the Division's transactions have been shown to be very good and better than most money managers.

The Division will contact several outside transaction measurement services and obtain estimates for equity transaction measurement services.
The human resources available to manage the international investment portfolio are insufficient.

Human Resources

The relationship of the administrative costs of the entire division versus the fair market value of the total assets under management is presented below:

The division’s administrative costs ($4.5 million) in 1996 totaled .8 basis points of the value of the assets. This is a low cost for a large institutional investment program. Basis points are a term used to measure administrative costs relative to assets under management, and 100 basis points are equivalent to 1%. A report issued by the Independent Fiduciary Services, Inc. in October of 1996 of the Texas Teacher Retirement System indicated that external management costs for assets the size of New Jersey’s would approximate 10 basis points or $53 million.

The number of employees available to manage the international portfolio of $9.7 billion at June 30, 1997 are too limited to properly monitor the economic,
political, and business sector climate for each of the 24 international countries in which the division has investments. According to an industry survey of the 1994 mutual fund industry, the average cost of managing a portfolio of this size is $800,000 higher than the division’s current allocation. In addition, the division must monitor other international areas for potential investment opportunity. The division’s international salary costs have increased from $200,000 in 1993 to $427,000 in 1997 while the international portfolio has increased from $2.5 billion to $9.7 billion.

**Recommendation**

We recommend that the Department of the Treasury provide more resources to the division in order to manage its rapidly expanding international portfolio.

**Auditee's Response**

The report also concluded that the resources of the Division are too limited, especially in the international area where the rapid growth in the past few years has occurred. We agree that the resources of the Division are too limited, and further believe that salary and Civil Service limitations inhibit the Division's activities. The resources available to the Division are the topic of ongoing discussions between the Director, the Council and the Treasurer.

\[\frac{1}{4}/2\]

**Custodian Banks**

The division is in violation of N.J.S.A. 52:18A-90.4 that requires the division to only utilize independent New Jersey based custodian banks to safeguard the investment securities. All the banks that the division had previously contracted with for custodian services have merged or been acquired by out-of-state banks and therefore do not meet the requirements of the statute.
Currently, the division is attempting to have the law revised to enable the division to contract with out-of-state banks for custodial services.

**Recommendation**

We agree with the division and recommend they continue their efforts to seek revisions to the statute.

**Auditee's Response**

The report also notes that the Division is in technical violation of the New Jersey bank custody law. The Director has been actively involved in modernizing this statute and it now appears to have all the necessary approvals and awaits legislative action (Bills S-2046/A-2916).

\[\frac{1}{4}\]