



**STATE BOARD OF ADMINISTRATION
OF FLORIDA**

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MEMORANDUM

To: Florida Rivera-Alsing, Chief of Internal Audit
From: Kevin SigRist
Date: January 11, 2008
Re: Requested Update on Internal Audit Report No. 2005-02

Attached is a staff update on the State Board of Administration's progress to date implementing the recommendations contained in Internal Audit Report No. 2005-02, Fixed Income Operational Audit—Trading Activities (released March 17, 2007).

Summary of SBA Progress Internal Audit Report No. 2005-02

Recommendation	Status	Expected Completion
1a. to 1d.	In progress	March 31, 2008
2a. to 2b.	In progress	March 31, 2008
3	In progress	March 31, 2008
4	Completed	NA
5	In progress	June 30, 2008
6a. to 6b.	Completed	NA
7a. to 7b.	Original management response stands	Ongoing
8a. to 8b.	Original management response stands	Ongoing
9a. to 9b.	In progress	March 31, 2008
10	In progress	March 31, 2008
11a. to 11b.	Completed	NA
12a. to 12 b.	Completed	NA
13	Completed	NA
14	Completed	NA
15a. to 15b.	Completed	NA
16a. to 16b.	Completed	NA
17	Completed	NA
18	Completed	NA
19a. to 19b.	Completed	NA
20a.	In progress	January 31, 2008
20b.	Completed	NA

Attachment

Recommendation 1: Overall Risk Management Framework

Recommendation	Status	Expected Completion
1a.	In progress	March 31, 2008
1b.	In progress	March 31, 2008
1c.	In progress	March 31, 2008
1d.	In progress	March 31, 2008
1e.	In progress	March 31, 2008

Audit 2005-02 Recommendations

1. a. Creation of a RMC (Risk Management Committee) reporting directly to the Executive Director. RMC should provide the main support to the Executive Director in managing risks at the institutional level. RMC should be responsible for identifying and understanding the key risks relevant to the SBA, defining the SBA's risk management strategy by clearly articulating the types of relevant risks, acceptable levels of exposure to specific risk types, counterparties, and business activities, and ensuring that the risk strategy is implemented through the development of appropriate procedures and investment in systems. The risk management strategy should be submitted on a regular basis to the Executive Director for review and approval.

RMC should put in place quantitative risk management standards (limits, value at risk measures, etc.), assess the less quantifiable risks (such as operational, legal, reputational, etc.), and set up procedures to deal with them. RMC should also initiate and maintain a set of limits to manage and restrict the maximum amount of risk across asset classes. These sets of limits should be approved by the Executive Director.

We understand that sometime ago, the SBA had a Risk Committee which was later absorbed by the Asset Allocation Committee. Alternatively, the SBA may delegate the responsibilities mentioned above to the Asset Allocation Committee.

b. Generally Accepted Risk Principles recommended linking a number of support and control functions, also independent of the trading and related functions, into the RMC to ensure implementation of risk management in all aspects of the SBA's business activities. We believe that the support for the RMC is going to be provided mainly by the enterprise risk management function. Other functions within the SBA that may report to the RMC on a regular basis to the extent to which they deal with risk management issues include investment policy and economics, credit management, legal, compliance, human resources, and information technology.

c. Being the main support to RMC, the enterprise risk management function has a critical role in day-to-day management of SBA-wide quantifiable risks. The role of the enterprise risk management function is to ensure that risk policies associated specifically with market, credit, and liquidity risks arising from trading activities are implemented. It must ensure that these are within approved limits, properly understood, and evaluated before transactions are undertaken, are monitored on an ongoing basis, and are reported to the Executive Director and the RMC in a timely manner. Enterprise risk management should be able to produce reports that highlight positions, limits, and excesses. This report

should be sent to the Executive Director and the RMC, reviewed, signed, and returned to enterprise risk management staff. The Chief of Client Services and Enterprise Risk Management should be a member of RMC.

d. Creation of a central credit management function independent of the trading and related functions. This credit function should be responsible for the evaluation of all counterparties and issuers' creditworthiness, the setting of counterparty credit limits, and monitoring of counterparty exposure. The head of credit management function should be a member of the RMC.

e. Linking the staff performing compliance function at the asset class level into the enterprise risk management function by establishing a dotted reporting line to the Chief of Client Services and Enterprise Risk Management. While compliance staff at the asset class level will continue to report directly to the SIOs or their designees, the dotted line will facilitate the monitoring of compliance activities and the results of such activities at the institutional level.

Management Update

Management agreed to consider all of the above recommendations within the context of Strategic Objective 1.11: Establish an Enterprise Risk Management Function. As indicated in the original management response, in July 2005 the Executive Director created an Enterprise Risk Management Unit and in November 2005 Strategic Objective 1.11 was created. Since the Audit recommendations were received, Strategic Objective 1.11 has continued to progress and staff believes it is substantially complete.

As background:

1. In June 2006, the Enterprise Risk Management (ERM) function was transferred to the Senior Operating Officer for Planning, Policy and Administrative Services from the Chief of Client Service and Enterprise Risk Management. The latter position was eliminated as the incumbent was hired into the Deputy Executive Director position (created when the incumbent Chief Investment Officer terminated SBA employment).
 - a. The Senior Operating Officer has a dotted line reporting relationship to the Executive Director for ERM responsibilities and beginning January 2007 biweekly meetings with the Executive Director were scheduled.
 - b. The original Manager of Enterprise Risk Management and Compliance terminated SBA employment in July 2006 and a new ERM employee was hired in December 2006. Summaries of the weekly activities of the current Manager of Enterprise Risk Management and Compliance are attached in Appendix 1.
2. The initial draft work plan was prepared in March 2006 by ERM, with the participation of the Inspector General (see Appendix 2).
3. ERM has been integrated into the policy development and review process since 2005. Activities include:
 - a. Participation in review and redrafting of Local Government Investment Pool Guidelines in Spring 2007 and issuance of revisions in November 1, 2007 and December 21, 2007.
 - b. Similar participation in CAMP MM guidelines revisions.

- c. Updating and drafting of 10-level policies on derivatives and leverage and asset class policies.
 - d. Reviewed Investment Manager Retention and Termination Policy, Investment Protection Principles, General Performance Measurement Policy, Tactical Asset Allocation Policy, and Investment Policy Statement Plan Design Risk Policy.
4. As described below, in mid 2006, ERM worked with Mellon Bank to develop custom consolidated derivatives counterparty report that cover separately managed FRS accounts. This effort followed from the 2005 R.V. Kuhns derivatives review commissioned by the SBA. Data communication is being put in place in order to extend this reporting to incorporate FRS Pension Plan commingled accounts derivatives counterparty risk exposure.
 5. In the Fall 2006 and early 2007, SBA conducted a competitive solicitation and review of total fund risk management systems with the participation of members of the Senior Investment Group and ERM. The competitive solicitation process was suspended as the system was not deemed cost-effective relative to the existing risk management systems already used within the public market asset classes, the risk budget and other risk measurement provided by SBA consultants.
 6. In late August and early September 2007, ERM conducted meetings with all SBA units, covering senior management to manager/director level, to promote risk awareness, discuss risk self-assessments and assist business units in developing a formal business unit risk management plan. As part of that exercise, ERM required each business unit to submit a self-assessment of risks. ERM had received the responses by November 1, 2007 and continues to review them. The risk assessment template and examples (included in Appendix 3 are sample material and a Fixed Income response). The templates were developed after reviewing the two key references cited in the 2005-02 audit—both of which were distributed to investment staff prior to the ERM meetings:
 - a. Public Pension Systems: Statement of Key Investment Risks and Common Practices to Address those Risks.
 - b. 20 Risk Standards for Institutional Investors and Institutional Investment Managers.
 7. Strategic Objective 1.11 was one of the primary agenda items at the November 1, 2007 SBA Strategic Planning offsite. The update prepared for that meeting can be found in Appendix 4.
 8. The key remaining steps in the ERM Program are to complete an assessment of SBA organizational level risks and development of response strategies including organizing the ERM Steering Group. The latter will meet in the first quarter of 2008 to review business units' self-assessment of risks, identify and develop responses to institutional-level risks, and finalize the ERM Policy.

Update on Recommendation 1a.

Recommendation 1a. states that: “We understand that sometime ago, the SBA had a Risk Committee which was later absorbed by the Asset Allocation Committee. Alternatively, the SBA may delegate the responsibilities mentioned above to the Asset Allocation Committee. (emphasis added)”

The Senior Investment Group is the successor to the Asset Allocation Committee and began meeting in mid June 2006 with an expectation that it would consider a wide range of investment issues including performance/risk reviews and new investment products (see Appendix 5 for sample materials). ERM is included in Senior Investment Group meetings.

The Senior Investment Group has participated in a number of risk management activities since inception, notably the risk-reducing revisions to the FRS Pension Plan Investment Policy Statement approved by the Trustees in May 2007 (i.e., asset liability study), risk budgets, asset transitions related to the FRS Pension Plan policy changes, review of new potential Strategic Investments opportunities and other new investment products, and periodic reviews of the market and active risk environment. Risk budgets, reviewed by the Senior Investment Group and approved by the Executive Director, establish quantitative risk management standards for the FRS Pension Plan and the Chiles Endowment.

As an example of the Senior Investment Group's activities reviewing the market and active risk environment, on August 23, 2007, the Senior Investment Group and consultants from Ennis, Knupp + Associates and Wilshire Associates discussed the following agenda items:

1. Impact of recent market volatility on asset class performance and portfolio management;
2. Material sectors/instruments that are receiving particular focus from the asset class and/or portfolio managers due to perceptions of heightened risk; and
3. Tactics being used to manage, mitigate, avoid, or exploit the recent market volatility and changes in relative valuations.

Update on Recommendation 1b.

The Senior Operations Group also began meeting in 2006 to primarily focus on the middle and back office activities that support and control the SBA's investment programs (see Appendix 6 for sample materials). The Senior Investment Group coordinates with the Senior Operations Group in various activities, including considering risk management issues. The Executive Director, Deputy Executive Director, Senior Investment Policy Officer and ERM attend both the Senior Investment Group and Senior Operations Group meetings. In practice, the first agenda item for each Senior Operations Group meeting is a briefing by the Deputy Executive Director on Senior Investment Group activities.

Update on Recommendation 1c.

To date ERM has largely utilized existing reports and the reporting capabilities of Mellon (i.e., custodian), Eagle (i.e., SBA's portfolio accounting system) or asset class analytics to review compliance with policies and guidelines. As an exception to the previous sentence, ERM worked with Mellon to develop a custom consolidated derivatives counterparty report (see below). Additional reporting capabilities and staffing procedures will be reviewed as Strategic Objective 1.11 is finalized.

Update on Recommendation 1d.

Credit underwriting of ISDA counterparties is performed by or in consultation with Fixed Income staff, regardless of which asset class will utilize the counterparty. The General Counsel's office reviews the legal form of guarantee of parent to subsidiary and reviews ISDA confirmations. Process changes resulted from ERM's benchmarking with several large money managers in early 2006. New broker/dealers provide their financials to the Deputy Executive Director's Office and pertinent asset classes. In early 2006, ERM reviewed all ISDAs and the

associated counterparties with respect to risk exposures. ERM has also been integrated into an ongoing review of counterparty risk associated with derivatives and securities lending.

1. In mid 2006, ERM and Mellon developed a consolidated derivatives counterparty report that covers all FRS Pension Plan assets custodied at Mellon. On a monthly basis, Mellon computes counterparty risk exposure which is reviewed by ERM, asset classes and the Deputy Executive Director's office. ERM has compared significant counterparty risk exposures against a monitoring threshold based on Tier 1 capital. ERM and the Deputy Executive Director's office is near completion with respect to finalizing comparable reporting on the SBA's external commingled funds derivative counterparty risk exposures.
2. ERM has reviewed the SAS 70 reports of the SBA's securities lenders with respect to controls and creditworthiness and made suggestions to lenders regarding certain controls that should be tested in their future SAS 70 audits.

Update on Recommendation 1e.

ERM continues to be integrated into the asset class compliance function through regular compliance reviews and reporting, while remaining independent of the subject business units.

1. ERM's participation has been in conjunction with reassigned activities of the Manager of Research and Compliance (in the Office of the Deputy Executive Director). The duties of this latter position were set out in August 2006.
2. As of November 1, 2007 ERM was added to the Investment Oversight Group for the Local Government Investment Pool and CAMP MM.
3. ERM has participated in review and development of the divestment compliance program.

Remaining Activities:

1. Complete an assessment of SBA organizational level risks and development of response strategies including organizing the ERM Steering Group. The latter will meet in the first quarter of 2008 to review business units' self-assessment of risks, identify and develop responses to institutional-level risks, and finalize the ERM Policy.
2. Finalize Enterprise Risk Management policy

Recommendation 2: Identification of Relevant Key Risks and Setting Risk Limits

Recommendation	Status	Expected Completion
2a.	In progress	March 31, 2008
2b.	In progress	March 31, 2008

Audit 2005-02 Recommendations

- 2a. We recommend that the SBA adopt Risk Standards 7 and 8 included in the Risk Standards for Institutional Investment Managers and Institutional Investors.
- b. We also recommend that the SBA review the applicability of the remaining 18 standards.

Management Update:

Management agreed to consider the above recommendations within the context of Strategic Objective 1.11: Establish an Enterprise Risk Management Function and continues to do so.

To that end, as noted above, in late August and early September 2007, ERM conducted meetings with all departments, covering senior management to manager/director level, to promote risk awareness, discuss risk self-assessments and assist business units in developing a formal business unit risk management plan. As part of that exercise, ERM required each business unit to submit a self-assessment of risks. ERM had received the responses by November 1, 2007 and continues to review them. The risk assessment template and examples were developed after reviewing the two key references cited in the 2005-02 audit—both of which were distributed to investment staff prior to the ERM meetings:

1. Public Pension Systems: Statement of Key Investment Risks and Common Practices to Address those Risks.
2. 20 Risk Standards for Institutional Investors and Institutional Investment Managers.

ERM will complete an assessment of SBA organizational level risks in the first quarter of 2008, (in part) by considering the compilation and analysis of business units' self-assessment of risks—including reference to “Risk Standards 7 and 8 included in the Risk Standards for Institutional Investment Managers and Institutional Investors” as recommended.

Nonetheless, management again notes that the July 2000 publication, *Public Pension Systems: Statements of Key Investment Risks and Common Practices* has been officially endorsed by the Association of Public Pension Fund Auditors, National Association of State Retirement Systems, the National Council on Teacher Retirement and the Government Finance Officers Association. This July 2000 publication does not explicitly incorporate Risk Standards #7 and #8.

In the Fall 2006 and early 2007, SBA also conducted a competitive solicitation and review of total fund risk management systems with the participation of members of the Senior Investment Group and ERM. The competitive solicitation process was suspended as the system was not deemed cost-effective relative to the existing risk management systems already used within the public market asset classes, the risk budget and other risk measurement provided by SBA consultants.

While risk limits will continue to be evaluated with respect to level, coverage and aggregation, they exist at multiple levels throughout the SBA's portfolios and are subject to regular compliance reviews:

1. Florida law limitations.
2. Asset allocation.
3. Risk budgets for FRS Pension Plan and Chiles Endowment.
4. Sub-asset class limits (i.e., strategic plans for private equity, real estate, domestic equities and fixed income).
5. Portfolio guidelines setting forth limits on securities held, credit quality, duration, industry concentration, issuer concentration etc.

Remaining Activities:

1. Complete an assessment of SBA organizational level risks and development of response strategies including organizing the ERM Steering Group. The latter will meet in the first quarter of 2008 to review business units' self-assessment of risks, identify and develop responses to institutional-level risks, and finalize the ERM Policy.
2. Finalize Enterprise Risk Management policy

Recommendation 3: Introduction of New Products

Recommendation	Status	Expected Completion
3	In progress	March 31, 2008

Audit 2005-02 Recommendations

3. a. To ensure that risks and other operational issues related to new products and major variants of existing products are addressed, we recommend that a new product policy be created. The new product policy should address the following:
 - Establishment of an approval process. According to the Counterparty Risk Management Policy Group II, "Toward Greater Financial Stability: A Private Sector Perspective" (July 2005), Guiding Principle # 24 (Category 1), the new product approval process should, at a minimum, have the following features:
 - Effective internal communication as to the classes of activity that are subject to the review process.
 - The involvement of independent control personnel.
 - Reasonable expectations that the necessary operational and related infrastructure to support the new product are in place.
 - To the extent that such expectations are not being realized, should be prepared to limit or curtail such business until the support infrastructure is well established.
 - Adequate training of sales and related personnel.
 - Rigorous documentation.
 - Requirement of review and approval by senior level committee like the recommended RMC and all operational areas affected by such transactions such as enterprise risk management, credit management, investment policy and economics, financial operations, accounting, compliance, and legal. This policy should be evidenced by an audit trail of approvals before a new product is introduced.

Management Update

As noted in the management update to Recommendation 1a., the Senior Investment Group is the successor to the Asset Allocation Committee and has material risk management duties. As part of the policy development of the Senior Investment Group, potential agenda items were identified as:

- a. Investment research initiatives (e.g., commodities, portable alpha)
- b. New significant asset class strategies (e.g., 30/130 short-extension, foreign PE&RE, corporate governance mandates).
2. The Senior Investment Group began meeting in June 2006 and its supporting policy was approved in December 2006. The Policy states that the Group will review:
 - a. Investment research initiatives, including asset classes and sub-classes not currently utilized and significant new asset class strategies.
 - b. Any other investment policies, strategies, and tactics designated by the Group Leader.
3. The Senior Operations Group also began meeting in 2006 to primarily focus on the middle and back office activities that support the SBA's investment programs. The Executive Director, Deputy Executive Director, Senior Investment Policy Officer and ERM attend both the Senior Investment Group and Senior Operations Group meetings.
4. Since Summer 2006, new investment products and related operations/implementation issues have been reviewed with the Senior Investment Group and Senior Operations Group. For example, see Appendix 7 for material on 30/130 short-extension strategies and prime brokerage. Members of both Groups and ERM participated in the prime brokerage competitive solicitation. Similarly, both Groups were engaged in the development and execution of the asset transition plan to implement the revisions to the FRS Pension Plan Investment Policy Statement approved by the Trustees in May 2007. In practice, the first agenda item for each Senior Operations Group meeting is a briefing by the Deputy Executive Director on Senior Investment Group items.
5. With respect to generating a signature log evidencing review and approval by all affected business units, the contract staffing process creates such a log where external providers are utilized to implement new investment products, including amendments to ISDA schedules for derivatives.

Remaining Activities:

1. Finalize Enterprise Risk Management policy.

Recommendation 4: Selection of Benchmarks

Recommendation	Status	Expected Completion
4	Completed	NA

Audit 2005-02 Recommendations

4. a. To ensure transparency in the selection of performance benchmarks, we recommend approval by Senior Management. The non-requirement of performance benchmark for certain non-FRS mandates should also be approved by Senior Management.

Management Update

Management agreed that Senior Management should approve performance benchmarks or the absence of benchmarks. The following demonstrate progress achieved since the original management response.

1. For individual portfolio benchmarks that are sub-asset class in nature, new performance benchmarks are approved by the Executive Director and Deputy Executive Director through the manager search, approval of investment guidelines and contract staffing and execution process. Investment Policy and Economics also participates in staffing the new account setup forms for Mellon, which specify the benchmark. Examples include the Core-Plus and International Small Cap managers.
2. New single portfolio benchmarks or changes for single portfolio mandates were reviewed and approved through the contract staffing and execution process, account set up or staffing of investment policy guidelines through Investment Policy and Economics. Examples include Citizens bond proceeds accounts, Local Government Investment Pool and CAMP MM.
3. Portfolios that have specialized objectives (i.e., laddered bond portfolio) and have neither calculated performance nor benchmark are identified and approved by the Executive Director in the Annual Investment Report. Examples include Burnham Institute and Torrey Pines.

Notwithstanding the foregoing, the ERM policy will consider the advantages of an annual approval process of all benchmarks or non-benchmarks.

Recommendation 5: Performance Measurement

Recommendation	Status	Expected Completion
5	In progress	June 30, 2008

Audit 2005-02 Recommendations

5. a. To avoid conflict of interest or the appearance of impropriety, we recommend that performance numbers for certain non-FRS mandates are verified independent of the asset classes.

Management Update

Management agreed that performance measurement for certain non-FRS mandates should be independently verified outside of the asset class. Mellon has been selected to be the successor custodian for non-FRS mandates that would be subject to performance calculations. CAMP MM performance has been calculated by Mellon since the 2005-02 Audit. The Local Government Investment Pool assets transitioned to Mellon in late December 2007 and an independent calculation and verification process is being put in place. The same independent performance measurement processes will be put in place as other assets move.

Remaining Activities:

1. Transition of other non-FRS investment mandates to Mellon.

Recommendation 6: Trust Agreements

Recommendation	Status	Expected Completion
6a.	Completed	NA
6b.	Completed	NA

Audit 2005-02 Recommendations

6. a. To ensure that the SBA is in compliance with the law, we recommend that the requirement of F.S. 215.44(1) be reviewed by the General Counsel's Office, and then appropriate steps should be taken to ensure compliance.
 - b. To ensure that the SBA's responsibilities and liabilities over funds being managed are clear; we recommend that trust agreements are signed without exception.

Management Update

The accounts referenced in the 2005-02 Audit have been closed.

Recommendation 7: Trade Confirmations

Recommendation	Status	Expected Completion
7a.	Original management response stands	Ongoing
7b.	Original management response stands	Ongoing

Audit 2005-02 Recommendations

7. a. The function of trade confirmation be moved to FO. All trades should be confirmed promptly with the counterparty's operations or back office.
 - b. The SBA explore the possibility of sending confirmation to counterparties. There are different options available in the market that would facilitate this process.

Management Update

We will continue to reassess best practices in the industry and evaluate any opportunities to change our processes when determined appropriate.

Recommendation	Status	Expected Completion
8a.	Original management response stands	Ongoing
8b.	Original management response stands	Ongoing

Recommendation 8: Dummy Trades

Audit 2005-02 Recommendations

8. a. It is critical that the integrity of the SBA's records is maintained at all times. If the recording of dummy trades cannot be avoided, we recommend that procedures such as regular review by an individual in a supervisory position be put in place so that the recording of dummy trades is adequately controlled and monitored closely.

- b. For the asset transfers, additional controls should be in place to ensure that these do not have adverse effect on positions and profit and loss. Asset transfers should be monitored independent of the trading function.

Management Update

We will continue to reassess best practices in the industry and evaluate any opportunities to change our processes when determined appropriate.

Recommendation 9: Trade Concentration

Recommendation	Status	Expected Completion
9a.	In progress	March 31, 2008
9b.	In progress	March 31, 2008

Audit 2005-02 Recommendations

9. a. To ensure that the SBA is not exposed to unacceptable credit exposures, we recommend that the SBA establish counterparty limits.
 b. To increase transparency and avoid any appearance of impropriety, we also recommend a periodic review of summaries of trade volumes by broker.

Management Update

Management agreed to limit trading volume to a maximum of 30% for any one broker/dealer, excluding Repo trades and to monitor trades at least twice per year (i.e., June 30 and December 31). As indicated in the October 8, 2007 response to the KPMG Second Follow-Up, Fixed Income’s compliance group continues to run monthly reports showing the amount of trading with each broker/dealer. See Appendix 8 for data demonstrating that Fixed Income complied with the 30% limit for previous 6 month periods during calendar year 2006 and 2007.

Policy revisions based on the 2005-02 Audit were originally staffed in July 2006, agreed to and implemented, but were not formally approved. The Fixed Income Broker/Dealer Coverage Policy has been formally approved effective January 8, 2008 (see Appendix 8).

Remaining Activities:

1. Expanding system generated reporting by broker/dealer to cover all asset classes and all financial instruments (i.e., cash and derivatives).
2. Establishing and monitoring counterparty limits at the aggregate SBA-level consistent with Strategic Initiative 1.11.
3. Revising SBA Policy 10-012 Broker Dealer Relationships to incorporate aggregate SBA-level counterparty limits.

Recommendation 10: Absences from Sensitive Key Positions

Recommendation	Status	Expected Completion
10	In progress	March 31, 2008

Audit 2005-02 Recommendations

- 10. a. We recommend that the SBA adopt the same requirements as these would enhance its internal control system.

Management Update

We were unable to accomplish this assessment by December 31, 2007; however we will complete by March 31, 2008.

Recommendation 11: Fixed Income Documentation

Recommendation	Status	Expected Completion
11a.	Completed	NA
11b.	Completed	NA

Audit 2005-02 Recommendations

- 11. a. We would like to repeat the recommendation of KPMG that FI traders should always briefly document and retain rationales for broker selections and execution prices, particularly for large transactions in less liquid markets, and FI should utilize existing system capabilities to periodically provide summaries of transaction volumes by dealer.
- b. We also recommend that such documents be attached to the trade tickets and retained in accordance with the SBA’s document retention policy, Policy #20-131.

Management Update

With respect to Recommendations 11a. and 11b., as indicated in the October 8, 2007 response to the KPMG Second Follow-Up, Fixed Income has been attaching broker selection and pricing documentation to trade tickets since the fourth quarter of calendar 2006. Also, the “new” comment line on trade tickets can be used if additional information or explanation is required. Similarly, as indicated in the October 8, 2007 response to the KPMG Second Follow-Up, Fixed Income’s compliance group continues to run monthly reports showing the amount of trading with each broker/dealer.

Additionally, on a post-trade basis:

- 1. The Long-term desk reviews trade data collected from Mellon on a weekly basis for the internal portfolios with respect to suitability of the trades for those portfolios.
- 2. The Short-term desk reviews trade data collected from Eagle for the Local Government Investment Pool, CAMP MM, Gas Tax, IFAS and Debt Service on a daily basis with respect to suitability of the trades for those portfolios and reviews trade data on a monthly basis for the other portfolios under their management.

Recommendation 12: Trading Limits

Recommendation	Status	Expected Completion
12a.	Completed	NA
12b.	Completed	NA

Audit 2005-02 Recommendations

12. a. We recommend the establishment of appropriate trading limits as soon as possible.
- b. The SBA should also establish a formal process for approving trades above the established trading limits.

Management Update

With respect to Recommendation 12a., the following informal limits were developed with participation of the Deputy Executive Director, Senior Investment Officer-Fixed Income and trading staff in July 2006:

1. Short-term Desk -- \$750 million with the exception of Repo less than 15 days to maturity which is \$1.5 billion.
2. Long-term Desk -- \$500 million (USD equivalent).

Compliance exceptions over the calendar year 2006 and 2007 period consist of the following:

1. December 3, 2007 \$525 million buy of American Express Centurion Bank (cusip 02581FYL7; rated A+/Aa3/A+) for long-term portfolio (Entity 10120). This was a money market security purchased upon recommendation by the Short-term Desk to provide collateral within a long-term portfolio.
2. December 11, 2006 \$831 million buy of Berkeley Square Finance (cusip 08436FMC4; rated A-1/P-1) for Entity 16101. This was an overnight money market security that settled same day.
3. November 27, 2007 \$875 million buy of Federal Home Loan Bank Discount Note (cusip 313384PV5; deemed rated AAA) for Entity 16101. This was an overnight money market security that settled same day. The size of this transaction reflects the management decision to suspend asset backed commercial paper purchases at the beginning of November 2007.

There were two other trades that each exceeded \$750 million, but were the result of two traders coordinating and combining separate trading for their individual portfolios. This coordination was contemporaneously documented.

Policy revisions based on the 2005-02 Audit were originally staffed in July 2006, agreed to and implemented, but were not formally approved. The Fixed Income Internal Trading Policy has been formally approved effective January 8, 2008 (see Appendix 9).

Recommendation 13: ISDA Master Agreement

Recommendation	Status	Expected Completion
13	Completed	NA

Audit 2005-02 Recommendations

13. a. We recommend that FI continue to work with the General Counsel's Office to finalize the boilerplate schedule and to start the use of the 2002 master agreement as soon as possible.

Management Update

Going forward, all new ISDA master agreements are using the 2002 Master. The June 2007 agreements with Toronto Dominion and Bank of America used the 2002 Master. The Credit Suisse ISDA is currently in negotiation and based on the 2002 Master.

Recommendation 14: Investment Guidelines

Recommendation	Status	Expected Completion
14	Completed	NA

Audit 2005-02 Recommendations

14. a. To provide adequate guidance to all portfolio managers and to clearly state the required standards, we recommend that FI comply with its policy and develop adequate guidelines for all mandates being managed regardless whether they are discretionary or nondiscretionary.

Management Update

Investment guidelines have been established for the noted portfolios.

Recommendation 15: Segregation of Duties

Recommendation	Status	Expected Completion
15a.	Completed	NA
15b.	Completed	NA

Audit 2005-02 Recommendations

15. a. Counterparty underwriting for both short-term and long-term desks should be done only by credit and research.
- b. FI management study the structure of the short-term desk and operations so that adequate segregation of duties is established. If segregation of duties in this area is not possible, SIO-FI should provide close supervision to ensure that internal controls in place are not violated.

Management Update

With respect to Recommendation 15a., counterparty underwriting (broker/dealer selection) for both the Short-term Desk and Long-term Desk is performed only by fixed income credit staff.

With respect to Recommendation 15b., Fixed Income has made the following changes:

1. The Manager of Operations and Securities Lending now signs the compliance reviews of short-term portfolios.
2. Only authorized staff can trade.

Recommendation 16: Broker/Dealer Selection

Recommendation	Status	Expected Completion
16a.	Completed	NA
16b.	Completed	NA

Audit 2005-02 Recommendations

16. a. FI revise its policy #20-812 to include IPP in its selection criteria.
- b. FI develop procedures on how to apply the filter to ensure that the filter will be applied consistently.

Management Update

With respect to Recommendations 16a. and 16b., the Broker/Dealer Coverage Policy has been updated as of January 8, 2008 to include the use of a filter and ability to select broker/dealers under special situations. The latter have been applied in practice since mid 2006.

Recommendation 17: Reports Used to Monitor Broker/Dealer Compliance

Recommendation	Status	Expected Completion
17	Completed	NA

Audit 2005-02 Recommendations

17. a. To ensure the results of compliance activities can be relied on, it is important that reports used to evaluate compliance are complete and accurate. In this regard, we recommend that FI review the reports mentioned, make the necessary revisions, and establish procedures so that all reports used are reviewed on a regular basis.

Management Update

Fixed Income worked with IT to fix the earlier reports and they are now corrected and in use.

Recommendation 18: Trading Policy

Recommendation	Status	Expected Completion
18	Completed	NA

Audit 2005-02 Recommendations

18. a. To further strengthen FI system of internal control over trading activities, we recommend that FI develop a trading policy that includes the areas mentioned above. The trading policy should be communicated adequately, monitored continually, and enforced.

Management Update

Policy revisions based on the 2005-02 Audit were originally staffed in July 2006, agreed to and implemented, but were not formally approved. The Fixed Income Internal Trading Policy has been formally approved effective January 8, 2008 (see Appendix 9).

Recommendation 19: Trade Capture

Recommendation	Status	Expected Completion
19a.	Completed	NA
19b.	Completed	NA

Audit 2005-02 Recommendations

19. a. Required access to the trading systems be granted to long-term desk internal traders to allow them to input their own trades.
- b. Moving forward, long-term desk internal traders be required to input their own trades directly into the trading system.

Management Update

With respect to Recommendations 19a. and 19b., Fixed Income agreed to evaluate the recommendations. Fixed Income believes it is not cost-effective for the Long-term Desk portfolio managers to input trades, but management will continue to evaluate the issue.

Recommendation 20: Trading Authorization

Recommendation	Status	Expected Completion
20a.	In progress	January 31, 2008
20b.	Completed	NA

Audit 2005-02 Recommendations

20. a. To ensure that trades are done only by authorized internal traders; we recommend that FI Operations perform compliance procedures similar to what they do for broker.
- b. We also recommend that FI update the list of authorized traders immediately after personnel changes among the authorized traders. The updated list should be forwarded to authorized broker/dealers as is the customary practice of FI .

Management Update

With respect to Recommendation 20a., Fixed Income has kept a list of authorized traders current with the broker/dealers. For the Short-term Desk, only authorized traders are able to enter trades in Bloomberg. However, Fixed Income Operations will begin conducting compliance procedures similar to what is done for broker/dealers by the end of January 2008.

With respect to Recommendation 20b., Fixed Income has consistently updated the list of authorized traders immediately after personnel changes.

Appendices 1-9 attached

Appendix 1

Appendix 2

Appendix 3

Appendix 4

Appendix 5

Appendix 6

Appendix 7

Appendix 8

Appendix 9