Inside the Florida State Board of Administration: Mismanagement Made the Enron Loss Inevitable

Introduction

The Florida State Board of Administration's $335 million financial loss on its Enron stock — invested through Alliance Capital Management — was all but inevitable. Florida's public pension system loss was three times greater than any other public fund because the State Board of Administrators (SBA) lacked internal investment controls and continues to have ineffective monitoring safeguards. The SBA response to its Enron loss was to deny its responsibility and place full blame for the loss on Alliance Capital Management. [1] In addition to the Enron loss, this report documents numerous other problems caused by internal management failures Ultimately, these multiple system failures are the responsibility of the SBA trustees, who have a duty to manage the retirement trust funds with due care and for the benefit of plan beneficiaries and retirees. [2]

The story of Enron and the SBA is a case study of what can go wrong at a public pension fund when public fund fiduciaries do not adhere to a common set of best practices. [3] Throughout this report, we document a system that ignored standards of practice and the counsel of independent advisers and reviewers.

The Florida SBA is responsible for managing the investments of the Florida state government. The SBA invests the funds of approximately 25 different government agencies and trusts. The largest trust is the Florida Retirement System (FRS), the country's fourth-largest public pension system, with approximately $100 billion in assets. It serves more than 600,000 active members and 200,000 retirees.

The SBA is governed by a three-member board: Governor Jeb Bush serves as chairman, State Treasurer Thomas Gallagher is the SBA treasurer, and Comptroller Robert Milligan is the board secretary.

AFSCME's findings result from reviewing more than 15,000 pages of internal SBA documents obtained through the Freedom of Information Act and numerous independent evaluations by external fund reviewers. AFSCME Council 79 represents 110,000 Florida public service employees with a direct stake in the pension system's financial security and sound management.

Summary of Findings

AFSCME has documented numerous instances of poor SBA investment practices rooted in inappropriate and inadequate oversight by SBA's Board of Trustees, chaired by Governor Bush. In fact, the Enron debacle is simply the most recent in a series of management failures plaguing the SBA over the past three years. And, much like the response of the Enron board of directors, the SBA trustees abdicated their roles as responsible fiduciaries. In recent years, both internal managers and external consultants have raised warning signals pointing to the lack of auditing standards, inappropriate performance benchmarks and limited compliance procedures. Despite these warnings, the SBA Board of Trustees failed to take adequate action to systematically remedy any of the problems highlighted by the reviewers. These management failures led to a system in which the SBA was unable to effectively monitor Alliance Capital Management (Alliance). Effective management controls based on the practices of other large pension systems could have prevented or greatly reduced the retirement system's $335 million loss.

Compared with its public fund peer group, the SBA has over-invested in an actively managed equity portfolio rather than a passive indexing strategy — thereby increasing both investment risk and costs. Furthermore, the Alliance portfolio carried a disproportionate amount of risk in its actively managed equity assets. The independent consultant hired by the SBA never had access to the SBA trustees, and did not have the cooperation of senior staff in a way that would allow effective monitoring these high-risk investments.

Perhaps the greatest mistake made by the SBA trustees was their failure to appropriately monitor the investment performance of Alliance, even prior to its tremendous Enron losses. In fact, although the SBA claims that its role was limited to monitoring Alliance for overall performance, and that it would not second guess the Alliance investment strategy, administrators naively relied on Alliance's self-created benchmarks to rate its own performance. The SBA's outside consultant was not aware of this self-monitoring until the spring of 2002. At the same time, SBA investment staff members were rejecting the consultant's independent indices, which flagged a history of under performance. Tom Herndon, SBA executive director, and Coleman Stipanovich, SBA deputy executive director, should have been aware of these concerns about the performance monitoring of the Alliance portfolio, but kept Alliance's self-monitoring program in place.

SBA problems with monitoring and oversight in domestic equities — brought to light because of the Enron investment — were mirrored in other departments, including commission recapture, real estate and alternative assets. In addition, an independent review of the Office of Compliance found that its role was confused, inappropriate and in need of restructuring. This consistent history of internally inadequate controls throughout the organization indicates a lack of oversight and care by the SBA board.

The responsibility for the SBA's deficient track record rests with its board of trustees. The SBA trustees, under the leadership of its chairman, Governor Bush, should be held accountable not only for the Enron loss but for all its oversight failures, which made Enron an accident waiting to happen.

Unlike any other state investment councils or pension boards with investment powers, the SBA contains no representation from outside financial experts or plan participants and retirees either directly as fiduciaries or indirectly on advisory committees. This lack of accountability to those in the retirement system combined with the SBA trustees' practice of viewing investment activities from afar because of their numerous executive obligations, means that fundamental changes are required to the way fiduciary oversight is structured.

Summary Recommendations

This report raises the question whether the SBA trustees have failed as fiduciaries to the Florida Retirement System, thereby endangering the retirement security of Florida's 600,000 public service workers. Only during the past few months — under the scrutiny of state and federal investigations into Enron — has the SBA begun to look at reforming some of its policies and procedures. We urge the SBA to move immediately to implement effective oversight over its investment program; and that the state legislature quickly identify and pass structural reforms to remedy the management failures identified in this report.

To fix the Florida SBA's failures, AFSCME Council 79 calls for:

1. A full operational review of the SBA by an external compliance agency or consultant reporting its findings to the state legislature.

2. The creation of an independent auditor and independent evaluation of compliance procedures with specific lines of authority and direct accountability to the SBA Board of Trustees.

3. Establishment of the Florida Employees Retirement System as an independent authority with investment responsibilities and a separate board of trustees with specific authority to hire a chief executive officer. Plan participants and retirees should represent half the members on a reconstituted board of trustees.

4. A delay in the current implementation of the "investment plan" defined contribution program until the completion of the full operational review and reform of the management and oversight structure of the defined benefit plan.

Findings of SBA Deficiencies

I. The SBA public equity portfolio was significantly over-weighted in actively managed funds, as compared with its public fund peer group, increasing both investment risk and cost.

A. SBA's active investment strategy reduced investment returns according to state oversight reports.

"The SBA would have achieved significantly higher returns and paid considerably lower fees if it had made more use of passive style managers to invest in domestic securities. … SBA could achieve additional earnings, reduce external management fees, and reduce brokerage commissions by increasing the percentage of its domestic equity assets invested by passive style managers. … SBA would have earned an additional $400.2 million after deduction of management fees in Fiscal Year 1998-1999 if it had used passive style managers to invest 80 percent of its domestic equity funds instead of its actual allocation of 59 percent."
Office of Program Policy Analysis and Government Accountability (OPPAGA), "Investment of Florida Retirement System Assets Meets Goals, But Earnings Could Be Increased," Report No. 99-52, May 2000, p. 1, 3. [4]

"The SBA would have earned an additional $612 million in Fiscal Year 1996-97 if its external domestic equity active investment style managers performed as well as external passive investment style managers. It also would have saved $49 million in management fees if all of its externally managed domestic equity assets were invested by passive investment style managers."
OPPAGA Oversight Report,State Board of Administration's 1996-1997 Investment Report No. 98-10, August 1998.

B. SBA investment practice was out of step with its peer group of large public retirement systems such as the California Public Employees Retirement System and the New York City Employees Retirement System. Common practice for large public funds is to have a much larger percentage of its equity fund portfolio invested in passive indexes designed to reflect market performance, not actively managed accounts designed to beat market performance. State oversight reports repeatedly have called attention to this practice since at least 1998.

"Many other large public retirement systems use passive style managers to invest significantly higher percentages of their domestic equity assets than does SBA."
OPPAGA Program Review, May 2000, p. 4.

C. Neither SBA trustees nor the state legislature received appropriate justification for its active style investment strategy.

"If the SBA wants to continue to use active style managers, it should justify their use based on the managers' ability to add value to its domestic equity investments as a whole. Therefore it is particularly important that the SBA clearly inform board members and the legislature on how well active style managers as a group are performing relative to passive style managers."
OPPAGA Program Review, May 2000, p. 6.

D. Even if the SBA preferred active funds to passive funds, SBA's senior staff should have monitored its Alliance Capital Management portfolio more closely and addressed Alliance's problems, including high portfolio turnover, which caused expensive administrative costs.

"Alliance has always been our most active trading manager and also our highest commission manager. They pay higher cents per share for the following reasons: next day settlement, capital commitment, and heavy losses by the broker dealer on large commissions."
SBA's Alliance Teleconference Notes, Oct. 30, 2001.

II. The Alliance Capital Management account, which held Enron, carried a disproportionately large amount of risk within the SBA's actively managed portfolio.

A. Alliance's financials were significantly underperforming the rest of the SBA's actively managed portfolio.

"Our active managers struggled as a group in June [2001] and in aggregate lagged their target by 20 basis points. Alliance continues to be the main culprit. Al [Al Harrison, Alliance's SBA fund manager] underperformed his benchmark by 2.23 percent for the month and lagged by a whopping 8.46 percent for the fiscal year. Of all our active managers, only two [Alliance and Babson] will have to be reported as 'underperforming' for the fiscal year."
Susan Schueren's e-mail to Tom Herndon and Coleman Stipanovich, July 16, 2001. [5]

"EK [Ennis Knupp] has been submitting a quarterly report, which is distributed within the staff organization [SBA] and at least to Mr. Bjorkman, that concerns fund performance at the manager level … [comparing] to a style benchmark … analysis has consistently indicated that Alliance was not adding value, in contrast to results based on the agreed upon benchmark. Whatever [SBA's] Domestic Equity thinks of Sharpe's style benchmarks, the fact is that this information has been arriving there quarter after quarter."
Richard Ennis' e-mail to Tom Herndon, March 6, 2002. [6]

B. The SBA allowed Alliance to pursue a high-risk investment strategy as part of the internal management of its domestic equities portfolio. In addition to over investing in actively managed funds, most of the risk in the domestic equity asset class was carried by the Alliance portfolio, even though it was classified as a "value portfolio."

"Alliance had a disproportionate share of the active risk within SBA's Domestic Equity investments. Although Alliance had about 9 percent of the asset class dollars and 28 percent of the active money [as of Dec. 21, 2000], its share of risk was 44.8 percent."
Richard Ennis' e-mail to Susan Schueren, March 13, 2002.

III. Oversight and performance benchmarking for the Alliance Capital Management investment portfolio was either poor or compromised by conflicts of interest. Such failures might constitute a breach of fiduciary duty to the fund. [7]

A. SBA accepted the use of a performance benchmark created by Alliance to be the instrument through which Alliance would be evaluated. This conflicted performance benchmark was used against common practice among pension funds and was unbeknownst to the SBA's outside investment consultant.

"Ennis Knupp has a strained relationship with the DE asset class. Domestic Equities furnishes EK no information about its portfolio or oversight activities. … Benchmarks are a case in point. We were under the impression that the manager benchmarks were developed and maintained by the staff. Only after Alliance was terminated did we learn that their benchmark was one of their own devising. Benchmarks for managers are one of the most fundamental things pension fund staffs consult with their consultants on. Just before the

Alliance/Enron situation, we expressed to [SBA] Economics the concern that manager benchmarks were under the control of the asset classes, i.e., that neither the consultant, Economics nor State Street had any involvement whatsoever with the benchmarks, i.e., none of these parties was in a position to satisfy themselves as to the correctness, let alone appropriateness of the benchmarks. We expressed the opinion then that, from the standpoint of control, this procedure should be reviewed, especially for benchmarks lacking transparency as was the case in DE."
Richard Ennis' e-mail to Tom Herndon, March 6, 2002.

"Alliance has been creating their benchmark since 1988."
Susan Schueren's e-mail to Tom Herndon and Coleman Stipanovich in response to Ennis' e-mail, March 13, 2002.

B. When questioned extensively about SBA's "watch list" creation and uses, Tom Herndon and Coleman Stipanovich never revealed to the U.S. Senate Commerce, Science and Transportation Committee that the SBA relied on benchmarks created by Alliance itself — rather than independent consultants or internal staff — to determine when and how Alliance should be placed on its asset manager "watch list."

"Our concerns about Alliance's investments in Enron coincided with our broader concern about Alliance's performance for the Florida Retirement System. Alliance had suffered a period of poor performance unrelated to and before the Enron investments began. In 2000, we had put Alliance on a 'watch list' where they stayed until terminated on December 11."
Testimony of Tom Herndon before the U.S. Senate Committee on Commerce, Science and Transportation on the Consumer Impact of Enron's Influence on State Pension Programs, May 16, 2002. [8]

C. SBA violated internal systems controls in its revamped directed brokerage program by allowing Alliance to deliver incomplete information and miss reporting deadlines.

"As you are aware, we reorganized our directed brokerage program at the Florida State Board of Administration [FSBA] as of July 1, 1999. We asked that you use your best efforts to place commission trades for our account with the State Street Brokerage broker network for the purpose of commission recapture.

… We also directed you to provide an audited monthly report to the FSBA de-tailing use of our commissions for the benefit of your own account to the FSBA by the tenth business day of the subsequent month. As of this date [March 6, 2000], we have received only a partial response to this request for information."
SBA letter to Alliance, March 6, 2000.

IV. Objective compliance and performance monitoring of the public equity asset class encountered internal roadblocks.

A. Independent consultants hired by the SBA for monitoring and internal control purposes do not report to the trustees, contributing to the lack of oversight and accountability within the agency. Against best practice, consultants hired to monitor fund managers report to each SBA asset class director, causing conflicts and resulting in weak accountability. Outside state reviewers have highlighted the problem of the lack of management controls since at least 1998.

"I noted that with most public funds it is customary for the general consultant to report directly to the board of trustees, and most boards are adamant about this. Because of the governance structure in Florida, this isn't practical. Nevertheless, for the consultant to enjoy any form of independence — and for senior management, the Investment Advisory Committee, and the trustees themselves to benefit from the involvement of independent consultants — the consultants must report at least one level above the fray, so to speak."
Richard Ennis' e-mail to Tom Herndon, March 6, 2002.

"I totally concur with Richard's statement that consultants should report at the Deputy Executive Director and/or Executive Director level."
Susan Schueren's e-mail to Tom Herndon and Coleman Stipanovich in response to Richard Ennis' e-mail, March 13, 2002.

"The SBA is not currently providing the Legislature with information on the aggregate performance of active style managers compared to passive style managers. This information is needed for the Legislature to adequately oversee the SBA and evaluate the extent to which the SBA's decisions to actively or passively invest assets add value to investment performance. Consequently, we

recommend that the Legislature enhance its oversight of the SBA's investment performance. The Legislative should require the SBA to report information that clearly indicates the extent to which SBA decisions to allocate funds to active and passive style managers as a group adds value to its investment performance."
OPPAGA Program Review, May 2000, p. 6.

"SBA has some weaknesses in its management controls for ensuring data accuracy and reliability."
OPPAGA Program Review, January 1998, p. 1.

"SBA has not developed a system for reporting on whether its managers are adhering to Investment Plan guidelines."
OPPAGA Program Review, January 1998, p. 1.

B. SBA's compliance process lacked capacity to deliver formal, systematic, detailed compliance reviews.

"Although the office is called the 'Office of Compliance,' its written administrative procedures are descriptive of a typical internal auditing department. However, the office has not yet functioned in an internal audit capacity as fully described in its administrative documents.
Report on the SBA Office of Compliance, *Medallion Consulting*,
March 12, 2002, p. 4-5. [9]

"The compliance office activities mixed internal audit, inspector general, and compliance type roles. Documents would suggest that it was an internal audit office, but it delivered a mixed product line. A properly functioning internal audit department would include financial auditing, operational auditing, and the compliance auditing. The office should be renamed the 'Internal Audit Office'… you need a — focus that has more breadth and depth, which is really an internal audit focus, and not answered or addressed by OPPAGA or the AG specifically, although they should coordinate their efforts."
Investment Advisory Committee (IAC) Transcript, *Mr. Harding*, March 8, 2002. [10]

"In the present structure of the SBA the CO [Compliance Officer] reports only to the executive director. This reporting structure is in keeping with only 24 percent of the PERS surveyed. It does not provide presently for three key processes involving the board that are generally conducive to maximum independence of an internal audit office.
Report on the SBA Office of Compliance, *Medallion Consulting*,
March 12, 2002, p. 27. [11]

V. Repeated warnings about the Enron stock price collapse went unheeded by senior staff and the SBA trustees.

A. SBA failed to act on the fact that Alliance lacked adequate financial data to justify investing in Enron.

"Alliance buying Enron since August has clearly been a very bad mistake. … It is one thing to make an assessment about what a company is worth and have the price move downward from your target. It's quite another to continuously buy stock in a company where there are accounting issues that are well known to the Street. … This is frustrating. Alliance should have known better."
Trent Webster's memo to Susan Schueren, Oct. 24, 2001. [12]

"Al, who is a proponent of the 'known fact' theory at the present time, confirmed that he is investing in high quality companies as they achieve good results. Al is hopeful that Enron will turn out the same way. Al was asked if Alliance understands how Enron generates its earnings. Al responded that the earnings do look a little 'black boxy.' He conceded that Alliance might need to dig deeper into why the shorts are out there on various companies. … Al said that often you either believe in a company and their management, or you don't."
SBA-Alliance Teleconference Notes, Oct. 30, 2001.

IAC member Mr. Bjorkman said, "The 10/24/01 memo where, in essence, Alliance said we didn't understand the financials, I really don't understand how additional purchases occurred. … That 10/24 memo was pretty alarming to me. And it appears that it's a week before there was further discussion here."
IAC Meeting Transcript, March 8, 2002.

IAC member Dr. Nast said, "where he [Alliance's Al Harrison] says: 'We believe the investment success comes from the correct marriage of fundamentals gleaned from rigorous company specific research. … Stock selection is driven by strong fundamental research.'… He says, 'Alliance is inclined to, of course, add the positions and — on price — weakness and so forth, assuming company fundamentals are intact.' He's violated all of those. There were no fundamentals when the accounting is bogus. There are no fundamentals left. … I find a statement like that totally contrary to some of his other statements in here that the company was a little black boxy looking."
IAC Meeting Transcript, March 8, 2002.

VI. Problems with managing the public equity asset class were not isolated, again indicating the lack of appropriate oversight and monitoring systems by the SBA trustees. Other problem areas — identified by either external or internal monitors over the past three years — include the Commission Recapture Program, Real Estate Division and Alternative Asset Class Division.

A. The fraud in its Directed Brokerage Program reflected inadequate internal controls.

In 1997, before SBA's embezzlement scandal was publicized, SBA Executive Director Mr. Herndon said, "I frankly don't see it [directed brokerage and soft dollar programs] changing. … As unpleasant as it is, and it is unpleasant, we will continue to use it."
Pensions and Investments, "Equities Bring a Dilemma," June 9, 1997.

In 1999, the SBA discovered that a Florida State pension fund employee, Barbara Jacobs, had been embezzling more than $400,000 of untraceable monies for an unknown length of time from the pension fund's 'soft dollar' program. The soft dollar program converted funds from SBA's commission recaptures [broker rebates] into a sort of slush fund retained by brokers that the agency controlled by asking brokers to use the funds to pay off the SBA's other vendor bills. Ms. Jacobs was eventually convicted of committing frauds and swindles and money laundering, sentenced to two years in prison, and ordered to pay $423,000 in restitution to the Florida pension board account.
Tallahassee Democrat, March 25, 2000 and *Associated Press*, March 3, 1999.

"SBA's Executive Director Mr. Herndon said, 'We kind of got lulled to sleep. … It was the wrong person in the right place in terms of being the person that authorized the expenditures. … It's not something that has an auditable trail. … The fact of the matter is we probably should have made that conversion [earlier to a system of internal control]."
Associated Press, "Embezzlement Alleged at State Pension Agency," March 3, 1999.

B. Major deficiencies have been identified in SBA's Real Estate Program and Practices indicating a lack of clearly defined policies and procedures required for risk management.

“Daily operations of the program would be more effective through clearer articulation and observance of written policies and procedures. … Many written policies and procedures require substantial enhancement. Staff’s compliance with various procedures which we spot-checked was uneven.”
Evaluation of Florida Real Estate Program and Practices, Independent Fiduciary Services June 2000, p. 4.

“Internal Controls Should be Strengthened in Several Key Respects. ... Several inadequacies in the Real Estate Program do contribute to the program’s historic under performance. ... The Department currently lacks the tools to quantitatively evaluate the financial and risk characteristics of the real estate portfolio. ... How the overall structure and nature of the real estate portfolio compares to various benchmarks remains unclear ... 1. Articulation of policies is weak. 2. Articulation of procedures is weak. 3. Observance of policies and procedures is weak. 4. Communication of policies and procedures (‘P&P’) within the Department. Staff had different versions of some policies. Some of the policies provided by staff were not included in the P&P document we obtained from the CIO, Real Estate.”
Evaluation of Florida SBA Real Estate Program and Practices, June 2000.

Real Estate’s investment management fees suffered the following problems relating to program fees:

“1. The current fee structure is not mentioned in the P&P … 1b. Acquisition fees — based on information supplied to us in response to our request for detailed information on fees, we were informed that acquisition fees at SBA’s real estate program were 65 basis points [bp] relative to the fair market value of assets acquired for the FYE 6/96, 68 bp in FYE 1998 and 85 bp in FYE 1999. Over the period 1993-1999, acquisition fees have ranged from 60 to 131 bp. Why the range is so wide is unclear to us. Acquisition fees are not addressed in any of the contractual fee schedules. 1c. Asset management fees — SBA’s asset management fees were 46 bp in FYE 1997, 41 bp in ‘98 and 36 bp in ‘99. From 1993-1999, such fees ranged from 32 to 72 bp. Again, why the range is so wide is unclear to us. At SBA, the standard fee structure for real estate asset management consists of three components — base, incentive based on gross revenues, and incentive based on net operating income [NOI]. This is a novel structure; we are unaware of any other funds that utilize this. … The criteria for determining the level of the fees for each of these three components is hazy.”
Evaluation of Florida SBA Real Estate Program and Practices, June 2000, pp. 18-19.

C. Deficiencies have been identified in SBA's Alternative Investments Program and Practices that reflect management's failure to effectively operate this investment asset class.

"Planning documents, work plans, and policy and procedure statements relating to alternative investments were either out-of-date or still under development more than a year and a half after the creation of the Alternative Investments Department as a separate organizational entity. Absent current investment strategies, policies, and workplans, the SBA lacks a current framework for reasonably ensuring a coordinated and efficient approach to alternative investments management."
Auditor General, *External Manager Selection and Alternative Investments Management*, *Florida State Board of Administration*, *Report No. 02-043*, September 2001, p. 1.

VII. The SBA's board and governance structure lacks the ability to provide oversight and protection of retiree assets. That is because it is unrepresentative of plan member needs and its trustees are so distracted by numerous executive responsibilities that it cannot function as an appropriate fiduciary.

A. With no employee representation on its board or Investment Advisory Committee, the SBA's board and governance structure is the least representative of the 100 largest public pension funds in America.

- FRS ranks last in the total number of public employees on the SBA Trustee Board.

- FRS ranks last in the total number of active employees who are board members.

- FRS ranks last in the total number of retired employees who are board members.

- FRS ranks last in the number of board members elected by constituent groups.
  "Characteristics of 100 Large Public Pension Plans," National Education Association, September 2000.

B. SBA's plan to implement the defined contribution plan has impeded and delayed SBA's ability to perform a basic fiduciary audit.

"To be very frank, we are between the DB [Defined Benefit] plan and the investment issues associated with that, and trying to get the DC [Defined Contribution] plan up and running, just swamped. … And so my request of the Advisory Council is, if you have an interest in our doing this, we're happy to go ahead and do it. … but to plan on probably not actually engaging in the work until spring of next year when we have some time. Right now, I don't know who we would cut loose to spend time with the auditors, simply because everybody is swamped with DC work."
Tom Herndon, *SBA executive director*, *IAC Transcript*, Dec. 14, 2001, p. 124.

"I would just like for it [fiduciary audit] not to get — to not get lost in the shuffle, because, for me, it's going to be an integral part of where the compensation review and the incentive package proposals go."
Russell Bjorkman, *IAC chair*, *IAC Transcript*, Dec. 14, 2001, p. 127.

"I think it's something that definitely needs to be done. I'm concerned also about the timing that — given that the staff is — is loaded with things, trying to put the DC plan in place, as well as manage the DB plan — on a continuing basis. I think a time schedule needs to be looked at so that we aren't sitting here four years from now talking about still doing a fiduciary audit."
Dr. Donald Nast, *IAC member*, *IAC Transcript*, Dec. 14, 2001, p. 129.

AFSCME's Recommendations for Action

To address the multiple failures at Florida's State Board of Administration, AFSCME calls for:

■ A full operational review of the SBA by an external compliance agency or a consultant with fiduciary powers who reports to the state legislature.

The stunning $355 million loss on Enron stock held by the Florida public pension system — three times greater than any other state retirement fund — has called attention to the internal oversight and monitoring problems that plague the SBA. An outside review by an independent fiduciary that reports to the state legislature would be an effective first step in identifying the full extent of the problems at the agency and putting in place corrective action.

Performance audits — also known as operational reviews — are growing as a standard evaluation tool for public pension funds. Full operational reviews have recently been performed at the Ohio Public Employees Retirement System, Washington State Investment Board and Illinois Teachers' Retirement System. To improve effectiveness, an external consultant acting as a delegated fiduciary to the SBA should implement the performance audit. The investment in a strong performance audit should generate significant returns in lowered administrative costs and expenses; stronger information systems; increased trustee, staff and public knowledge; and increased support and trust from beneficiaries, decision-makers and the public.

The SBA system staff lacks the technical expertise and resources to perform adequate oversight. It is inappropriate for current investment consultants to serve as auditors or compliance evaluators without adequate oversight.

Florida's pension participants deserve to know that a competent outside expert has monitored and validated SBA's compliance policies, procedures and activities. SBA trustees should move immediately to make an outside performance audit a standard business practice. Failing that, the state legislature should move to enact legislation requiring regular performance audits.

■ The creation by the SBA of an office of "Independent Auditor" with direct lines of authority and direct accountability to the SBA Board of Trustees, along with independent procedures for compliance.

Consultants report that the internal audit function at the SBA is non-operative. A strong and independent auditor is necessary to implement regular internal audits and to strengthen SBA's management practices and achieve greater accountability. The lack of an internal auditor exacerbated many of the SBA's system failures. According to best practice the internal auditor should report directly to trustees.

■ The restructuring of the Florida employee retirement system as an independent authority, with investment responsibilities and a separate board of trustees with direct authority to hire a chief executive officer. Plan participants and retirees should represent half the members on a reconstituted board of trustees.

The Florida State Board of Administration and Florida Retirement System need structural overhauls to make sure that they operate for the exclusive benefit of Florida public employee retirees and use appropriate systems for oversight and monitoring. Florida's retirement system is one of a very few systems nationally that operates without the oversight of a strong and independent Board of Trustees. The director of investments is an employee of the state government, not the retirement system. Investment decisions for the system are governed by a three-person board — made up of the governor, treasurer and state comptroller. Unlike other systems with sole fiduciaries or government officers who designated fund trustees, the SBA offers no formal involvement of plan participants and retirees through its advisory boards.

We will urge that the legislature establish an independent retirement system with its own investment powers. The new system should include plan members and beneficiaries to ensure that retirement security for plan members comes first. Such structures are common among large public funds. According to the National Education Association's *Public Fund Characteristics Report*, active employees make up 14 percent of total board members, while retired members account for 44 percent of the 100 large pension funds. The median size of the boards was nine members, with a median number of three elected trustees and three gubernatorial appointees. The best way to promote strong oversight and monitoring of investments is to include equal representation of active and retired members as trustees with fiduciary responsibilities.

■ A moratorium on the continuing implementation of the "investment plan" until the completion of the full operational review and the reform of the management and oversight structure of the defined benefit plan.

None of the important and complex issues raised in this review can be resolved without the complete and full attention of the SBA trustees and senior staff. The creation and initial implementation of the defined contribution program known as the investment plan has distracted trustees from their important fiduciary duties to Florida public employee's retirement funds. A very small percentage of employees have selected the investment plan option, so few would be affected if a moratorium were imposed on the plan. Such a moratorium and operational review would rebuild confidence that public employees' money was being wisely managed by the SBA. It would allow the trustees and staff to focus their energies on correcting fundamental flaws in the operation of the SBA.

Notes

[1] See "proposed testimony of Thomas Herndon, executive director of the Florida State Board of Administration presented to the Senate Committee of Commerce, Science and Transportation at the May 16, 2002 hearing."

[2] Florida State Statutes Chapter 215.44 Board of Administration; powers and duties in relation to investment of trust funds.

[3] See "Public Pension Systems: Statements of Key Investment Risks and Common Practices to Address Those Risks," Association of Public Pension Fund Auditors, July 2000. Also endorsed by the National Association of State Retirement Administrators and the National Council on Teacher Retirement.

[4] Florida's Office of Program Policy Analysis and Government Accountability provides analysis of state policies and services to assist the Florida legislature in decision-making, and to ensure government accountability.

[5] Tom Herndon was the executive director of the SBA who retired in June 2001; Coleman Stipanovich is currently the deputy executive director, nominated to replace Herndon. Susan Schueren is the chief of domestic equities for the SBA who reported directly to Stipanovich during this period.

[6] Richard Ennis is the chairman of the board and director of research at Ennis Knupp Associates. EK Associates is an independent investment consulting firm that provides advice to large institutional investors including a number of large public pension systems on the management and oversight of their investment programs. The Florida SBA has been a long-term client. The Sharpe's style benchmarks referred to here were created by William F. Sharpe, a Nobel Prize winner in economics. His performance benchmarks are widely used by investment consultants to analyze portfolio performance. He also is founder and president of Financial Engines, which was selected by the SBA to provide investment advice to its new investment plan participants.

[7] To avoid becoming the subject of liability for the actions of the service provider, a trustee must monitor the performance of the service provider on an ongoing basis, according to Carol V. Calhoun and Cynthia L. Moore in the *Government Plans Answer Book*, Chapter 8, Page 12, Panel Publishers, 2002.

[8] See also Coleman Stipanovich's replies, U.S. Senate hearing transcripts, Pages 58-72.

[9] Medallion Consulting was engaged by the SBA to perform an evaluation of the role of the Office of Compliance. In this report, Medallion made 19 specific recommendations to overhaul internal compliance and auditing procedures.

[10] The Investment Advisory Committee is charged with reviewing investment policies and procedures. As its name implies, they are purely advisory and have no fiduciary or functional role within the SBA.

[11] A survey of 41 public retirement systems having internal auditing functions indicates that 34 percent of chief auditors report only to the board or audit committee, 41 percent report to both the board and executive director and only 24 percent report only to the executive director.

[12] Trent Webster is the manager of Domestic Equities who was responsible for tracking the Alliance Capital Management portfolio and the problems at Enron.

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