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# SLOCUM

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43 Main Street SE, Suite 148  
Minneapolis, Minnesota 55414  
P: 612.338.7020 F: 612.338.7034  
[www.jslocum.com](http://www.jslocum.com)

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**Philip Becker, CFA**  
**Senior Consultant**  
(612) 216-6336, [PhilB@JSlocum.com](mailto:PhilB@JSlocum.com)



**NORTH CAROLINA**  
**SUPPLEMENTAL RETIREMENT PLANS**  
**INVESTMENT GOVERNANCE RECOMMENDATION**  
**MARCH 2015**

# INVESTMENT GOVERNANCE GOALS FOR SRP

Slocum's recommendation incorporates the following goals:

1. Create a well defined structure with accountability and commitment to the governance model.
2. Use the strengths of both North Carolina's internal resources (SRP and IMD) and third-party resources (Mercer) to create a fiduciary oversight structure that enhances the experience for Supplemental Retirement Plan participants, following the administrative unbundling of the SRP structure.
3. Create a sustainable structure such that turnover of internal staff and/or third party resources will have minimal affect on the day-to-day management or the long-term viability of the Supplemental Retirement Plans.
4. Design a structure that emphasizes risk management and reduces the possibility of errors.
5. Identify a structure that minimizes costs for Plan participants but does not compromise quality.
6. Incorporate flexibility such that the Board can expand or contract its use of third party resources as needed over time.

# CURRENT STRUCTURE OBSERVATIONS

## ■ **Delegation of Responsibilities**

- The Supplemental Retirement Plans (SRP) are a large retirement system with inherent complexities due to its size. Due to the involvement of several parties, an opportunity exists to delegate various responsibilities of the Plans to streamline and improve the governance structure.

## ■ **Definition of Responsibilities**

- All parties involved with making SRP a successful program could benefit from having clearly defined roles to streamline processes and reduce long-term costs.
- Currently, there are multiple parties involved in compliance, manager fee negotiations, manager agreements, manager guideline formation and changes, and transition management.

## ■ **Staff and Resources**

- Historical turnover has led to some disruption of processes and procedures; however, current SRP staff has deep experience in the areas of plan administration, investments and legal.
- In addition, SRP has partnered with third parties such as IMD, Prudential, Mercer and Galliard to advise and execute various functions of the Plans. SRP would benefit from an additional dedicated staff member in conjunction with third party delegation to reduce and manage long-term costs, enhance plan oversight, and enhance processes and procedures.

# CURRENT STRUCTURE CHALLENGES

The following structural challenges have been identified by Slocum through interviews with SRP and IMD staff. The proposed solution for each issue is consistent with the recommended future investment governance structure.

- **Investment Manager Compliance Monitoring**
  - **Challenge:** Multiple data feeds are gathered from Prudential, Galliard, JPMorgan and State Street to confirm quarterly compliance of all investment managers relative to investment policy statement criteria.
  - **Solution:** The future unbundled structure will provide a single feed from the Plans' custodian to allow for daily monitoring of the portfolios. SRP and Mercer will be able to monitor compliance issues on a daily basis and provide issue resolution directly to the managers.
- **Investment Manager Guidelines**
  - **Challenge:** Multiple parties have been involved with negotiating and modifying investment manager guidelines.
  - **Solution:** SRP should lead the process for negotiating manager guidelines with input from IMD and Mercer. For minor guideline changes, SRP should be granted authority to approve. For major guideline changes, SRP should provide a recommendation to the investment committee for approval.
- **Fee Negotiation**
  - **Challenge:** IMD and Mercer have both participated in fee negotiations, leading to uncertainty on the part of the manager as to the authorized party for fee negotiations.
  - **Solution:** SRP should lead all fee negotiation efforts with support from IMD and Mercer.

# CURRENT STRUCTURE CHALLENGES (CONT.)

## ■ Transition Management

- **Challenge:** A lack of clarity exists regarding the party responsible for hiring transition managers.
- **Solution:** SRP should lead the transition manager hiring process with support from IMD and Mercer.

## ■ Legal Resources

- **Challenge:** SRP's dedicated legal resource is well equipped to handle the needs of the Plans under normal circumstances; however, over the course of the next 12-18 month period during the unbundling of the plans, there will be significant demand on this resource to re-contract with multiple investment managers as well as the recordkeeper and custodian.
- **Solution:** Mercer has offered support and access to their contracting and legal team as part of their proposal. In addition, SRP legal could leverage the established pool of external contract attorneys and external legal counsel.

# RECOMMENDATION OVERVIEW

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- **Slocum has provided recommendations for the future investment governance structure for SRP in the following areas:**
  - Investment Policy
  - Manager Selection, Monitoring and Termination
  - White Label Fund Construction and Oversight
  - Custom Multi-Asset Class Fund Portfolio (“GoalMaker”) Construction and Oversight
  - Investment Manager Contracting and Execution
  - Daily Operational Compliance Monitoring
  - Performance and Compliance Reporting

# SUMMARY OF RECOMMENDED GOVERNANCE MODEL

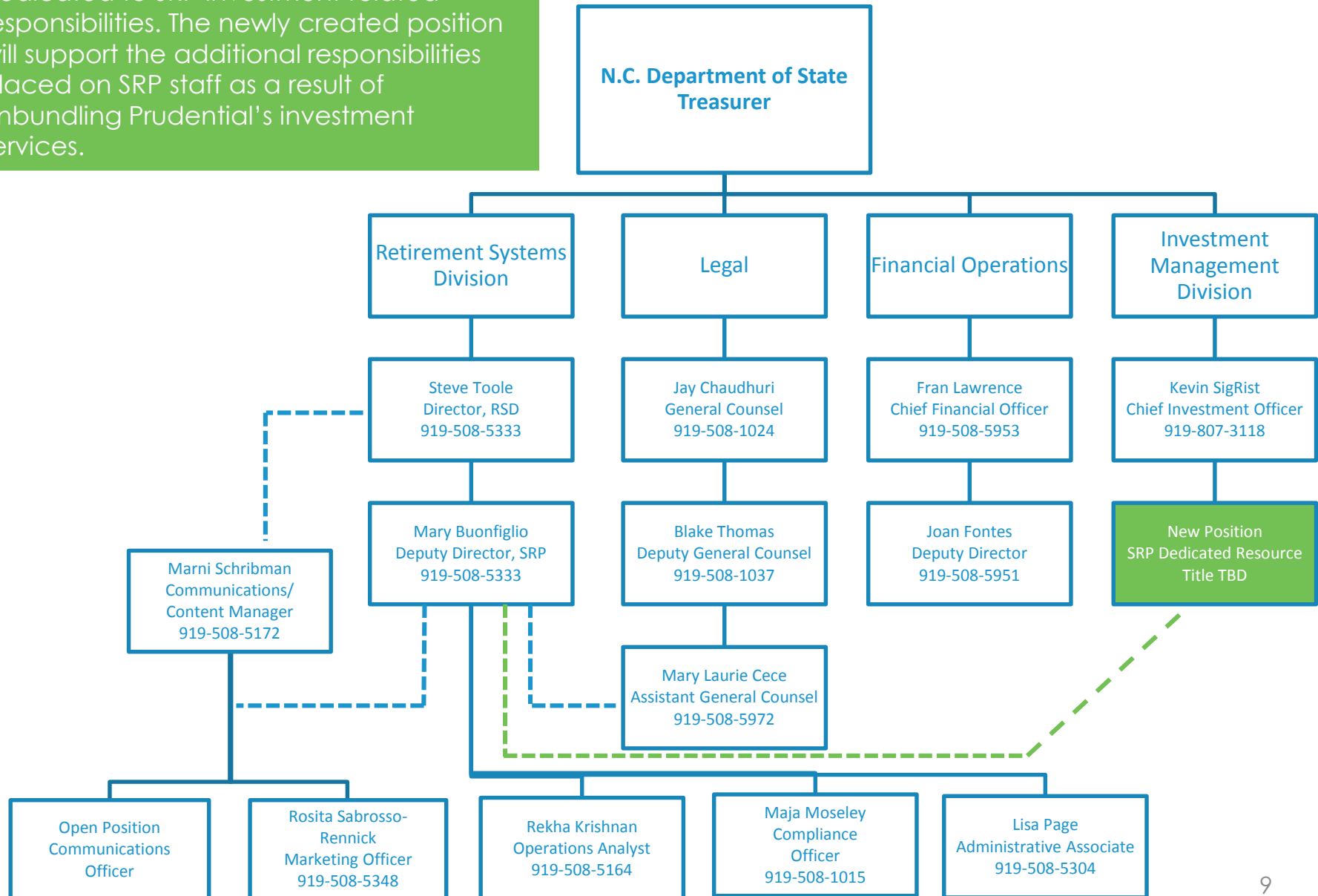
North Carolina	Task	Mercer
<b>Responsible</b>	<b>Investment Policy Development</b> including asset classes offered and custom fund objectives	<b>Advise/Support</b>
<b>Responsible</b> (including ERISA 3(38) investment managers)	<b>Manager Selection, Monitoring and Termination</b> including ERISA 3(38) investment managers and transition managers	<b>Advise/Support</b> (excludes ERISA 3(38) investment managers)
<b>Monitor</b>	<b>Custom Fund Construction and Compliance</b> includes custom multi-asset class and NCSRP white label funds	<b>Responsible</b> (asset allocation, rebalancing, cash flow management, etc.)
<b>Responsible</b> (delegated to SRP staff)	<b>Daily Operational Compliance Oversight</b> including resolution of compliance issues and guideline changes, as required	<b>Responsible</b> (trade rectification and issue resolution)
<b>Responsible</b> (delegated to SRP legal)	<b>Investment Manger Contracting and Execution</b>	<b>Advise/Support</b>
<b>Monitor</b>	<b>Performance and Compliance Reporting</b> quarterly Board meetings	<b>Responsible</b>

# CURRENT, RECOMMENDED AND ALTERNATIVE STRUCTURES

	Current	Recommendation	Alternative Structure #1 (Insource Compliance and White Label)	Alternative Structure #2 (Full Delegation)
<b>Investment Policy Development</b>	North Carolina	North Carolina	North Carolina	North Carolina
<b>Manager Selection, Monitoring and Termination</b>	North Carolina	North Carolina	North Carolina	Mercer
<b>Custom Fund Construction and Compliance</b>	North Carolina (Mercer assistance)	Mercer or TBD	Mercer or TBD = Custom Multi-Asset Funds	Mercer or TBD
			North Carolina = NCSRP White Label Funds	
<b>Daily Operational Compliance Oversight</b>	North Carolina (Mercer quarterly compliance assistance)	Mercer = Issue resolution and trade rectification	North Carolina	Mercer
		North Carolina = Oversight and issue resolution		
<b>Investment Manger Contracting and Execution</b>	Prudential and North Carolina	North Carolina	North Carolina	Mercer
<b>Performance and Compliance Reporting</b>	Mercer	Mercer	Mercer	Mercer
<b>Mercer Cost</b>	<b>\$200k</b> (based on bundled structure)	<b>TBD</b>	<b>TBD</b>	<b>~\$1.7 Million</b> (original asset based fee proposal)



Slocum recommends adding an additional staff member to IMD that is 100% dedicated to SRP investment-related responsibilities. The newly created position will support the additional responsibilities placed on SRP staff as a result of unbundling Prudential's investment services.



## RECOMMENDATION #1: INVESTMENT POLICY

### Recommendation: Board Retains Responsibility for Investment Policy

- **Rationale:** It is essential for the Board to maintain responsibility for the investment policy to control the following:
  - Investment objectives for the Plans
  - Responsibilities of the Board, internal staff and service providers
  - Service provider and internal staff delegation
  - Asset class structure and alignment with investment objectives
  - Investment objectives and benchmarks for individual managers and custom portfolios (NCSRP white label funds and custom multi-asset class funds)
  - Process for investment selection, monitoring and terminating managers
  - Implementation approach (active vs. passive) for each asset class

As the needs of the Plans change, the Board will have the ability to modify the investment policy accordingly.

- **Liability Considerations:** Maintaining control over the investment policy is a fundamental responsibility for a plan fiduciary. Liability for maintaining the investment policy can be managed through a sound governance, delegation, monitoring and reporting process.

## RECOMMENDATION #1: INVESTMENT POLICY (CONT.)

### Recommendation: Board Retains Responsibility for Investment Policy

- **Cost:** The cost for maintaining the Investment Policy is the Board's time as well as internal staff and third party consultant time and resources.
  - The Board should devote time at each quarterly meeting to review investments and plan governance relative to the stated investment policy.
  - SRP staff and Mercer should fulfill their responsibilities relative to the investment policy at each quarterly meeting as well on a regular basis between quarterly meetings.
  - Slocum recommends adding an additional dedicated resource to help with various components of managing the plan, including enforcement of the investment policy.
    - Additional SRP staff member would formally report to IMD, with a dotted line to SRP and be used as a dedicated resource
      - Additional SRP Staffing Cost: \$120,000 to \$180,000 (including benefits), depending on qualifications
  - Mercer advisory services for investment policy structure and compliance monitoring is embedded within their total proposed fee.
- **Critical Success Factors:** The following critical success factors have been identified for maintaining the Investment Policy:
  - Annual strategic review of the policy to ensure objectives, processes, procedures and delegation responsibilities are being met, as well as identification of changes that need to be made as a result of evolving needs and/or structural changes to the Plans.
  - Additional SRP staff resources to assist with overall enforcement and management of the investment policy.
  - Clear and concise reporting and scorecards provided on a quarterly basis by Mercer relative to policy criteria for easy identification of issues as they arise.
  - Daily compliance monitoring of the investments relative to established investment management guidelines for each manager and fund **(See recommendation #6 for execution of this task).**

## RECOMMENDATION #2: MANAGER SELECTION, MONITORING AND TERMINATION

### Recommendation: Board Retains Responsibility for Manager Selection, Monitoring, and Termination

- **Rationale:** The Board should maintain responsibility for investment manager selection, monitoring, and termination for the following reasons:
  - Historically, this task has been completed by the Board and, as Slocum has learned, completion of this responsibility has worked well with leadership from SRP staff and assistance from Mercer and IMD.
    - An opportunity exists for improved collaboration between SRP staff, IMD staff and Mercer to discuss potential changes to investment options and provide clear recommendations to the Investment Committee and Board.
    - It is recommended that the Board delegates responsibility for hiring transition managers to SRP (supported by IMD and Mercer) in the event of a manager termination.
- **Liability Considerations:** There is higher liability associated with maintaining this function relative to outsourcing; however, the Board, Investment Committee, SRP staff, IMD staff and Mercer have already established a framework for executing these decisions. From Slocum's perspective, liability can be managed by:
  - Enhancing processes and procedures for monitoring the investment options and custom portfolios relative to investment policy criteria.
  - Enhancing the current process for manager selection through additional collaboration between SRP, IMD and Mercer in addition to following established screening and selection criteria.
  - Continuing the current practice of documenting due diligence performed on managers prior to termination from the Plans.

## RECOMMENDATION #2: MANAGER SELECTION, MONITORING AND TERMINATION (CONT.)

### Recommendation: Board Retains Responsibility for Manager Selection, Monitoring, and Termination

- **Cost:** The additional SRP staff member will be critical for enhancing manager due diligence efforts, creating processes and procedures for succinct recommendations to the Investment Committee, and developing continuity with IMD. Mercer's advisory fee for supporting these services is included within their fee proposal.
- **Critical Success Factors:** The following critical success factors have been identified for manager selection, monitoring and termination:
  - **Manager Selection:** A transparent and repeatable process led by SRP staff that leverages Mercer and IMD to create well constructed recommendations for Investment Committee endorsement and Board approval.
    - The Investment Committee of the Board should ensure that a consistent and repeatable process is undertaken for the recommendation put forth by SRP (with support from IMD and Mercer). The Investment Committee should review the recommendation (along with supporting material) and ask questions to fully understand the manager recommendation. After this review, the Investment Committee should be in a position to endorse the recommendation for Board approval. In case the recommendation is rejected, it is SRP's responsibility to resolve issues with the recommendation and resubmit for endorsement. After Investment Committee endorsement, a formal recommendation should be put forth for final Board approval.
  - **Manager Monitoring:** Mercer will continue to provide performance reporting to the Plans, outlining performance relative to established benchmarks, manager performance detail, and compliance for each manager relative to investment policy criteria.
  - **Manager Termination:** A process must be established to track due diligence efforts, compliance issues and valid reasons before a termination occurs.

## RECOMMENDATION #3: NCSRP WHITE LABEL FUND CONSTRUCTION

### Recommendation: Board Outsources Responsibility for White Label Fund Construction

- **Rationale:** The Board, Investment Committee, SRP staff and IMD staff should focus efforts on evaluating manager performance and assessing investment managers rather than undertake investment management responsibilities.
  - Asset allocation and responsibility for the NCSRP White Label Funds is an investment management function and, as such, should be delegated to an external party.
  - Currently, the NCSRP White Label Funds have an equal weighting structure to the various managers assigned for each asset class. Slocum recommends that the Board evaluate ways to potentially improve performance, such as employing dynamic asset allocation. Dynamic asset allocation would allow the ERISA 3(38) investment manager to overweight or underweight managers with the goal of achieving more attractive risk-adjusted performance results over time. A high level comparison of the current “equal weighting process” compared to a more “dynamic process” is outlined below:

	Equal Weighting Managers (Current Approach)	Dynamic Approach (Potential Approach)
Inclusion of niche managers that may add value to the structure	No	Yes
Tactical positioning	No	Yes
Rebalancing methodology	Tight “tolerance bands” (+/- 2% relative to strategic targets)	Wider “tolerance bands” (+/- 10% relative to strategic targets, for example)
Specific return and volatility targets	No	Yes

- **Note:** The value added from Mercer’s dynamic asset allocation should be evaluated prior to implementation.

## RECOMMENDATION #3: NCSRP WHITE LABEL FUND CONSTRUCTION (CONT.)

### Recommendation: Board Outsources Responsibility for White Label Fund Construction

- **Liability Considerations:** A delegated ERISA 3(38) manager over the NCSRP White Label Funds reduces liability for North Carolina and provides clarity for responsibility of asset allocation decisions.
  - A more thoughtful approach to asset allocation, coupled with daily compliance oversight of each portfolio's asset allocation, should benefit SRP participants through potentially improved performance and enhanced risk controls.
  - The ERISA 3(38) investment manager will assume responsibility for daily management of the portfolios, including strategic manager weights, rebalancing, and tactical portfolio tilts (if permitted).
  - The investment policy should be reconfigured to acknowledge the purpose of these funds and outline specific investment objectives and benchmarks, including how the ERISA 3(38) investment manager's relative outperformance and underperformance will be measured.
- **Cost:** The cost for delegating this responsibility is embedded within Mercer's fee proposal. In addition, SRP staff and Board time will be required to oversee the ERISA 3(38) investment manager's performance for these funds. It should be noted, however, that that Board, Investment Committee and SRP staff will realize time savings as a result of delegating the daily management of the NCSRP White Label Funds relative to an environment where responsibility for asset allocation decisions is maintained.

## RECOMMENDATION #3: NCSRP WHITE LABEL FUND CONSTRUCTION (CONT.)

### Recommendation: Board Outsources Responsibility for White Label Fund Construction

- **Critical Success Factors:** The following critical success factors have been identified for outsourcing responsibility of NCSRP White Label Fund construction to an ERISA 3(38) investment manager:
  - The investment policy should specifically outline the investment objective of each fund (including risk and return targets and tactical asset allocation bands) along with monitoring criteria.
  - The investment policy needs to be modified to monitor the ERISA 3(38) investment manager's risk-adjusted performance relative to benchmarks.
  - As a manager to the Plans' assets, the ERISA 3(38) investment manager's performance needs to be monitored over time and, if warranted, could be terminated as manager of the White Label Funds if they are not managing to expectations. The policy needs to be modified to reflect a general framework for monitoring the ERISA 3(38) investment manager's capabilities for managing these funds as well as "watch list" and termination criteria.

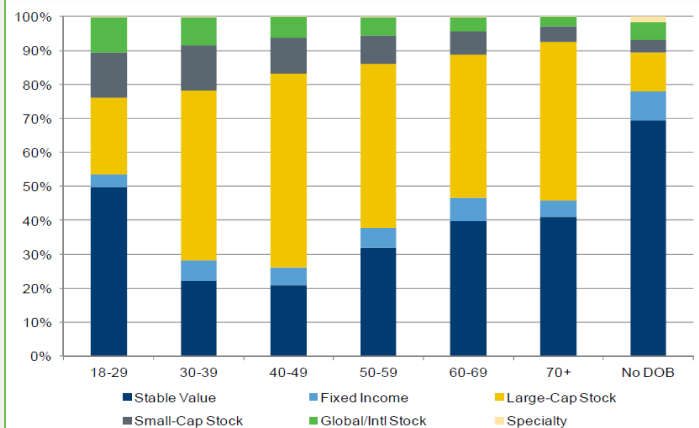


## RECOMMENDATION #4: CUSTOM MULTI-ASSET CLASS PORTFOLIO CONSTRUCTION

### Recommendation: Board Outsources Responsibility for Custom Multi-Asset Class Portfolio Construction

- **Rationale:** Custom multi-asset class funds are complex vehicles that require a combination of expert skill in portfolio construction and defined contribution plan management. As of 12/31/14, approximately 40% of plan assets were invested in custom multi-asset class investments (i.e. "GoalMaker"). Slocum projects that this area of the plan will continue to grow in terms of number of participants and assets. Given the complexity and importance of this asset class, it is in the best interests of the Board to outsource the asset management of these funds to an ERISA 3(38) investment manager.
  - Due to the unbundling of service providers, flexibility in this area is projected to be enhanced, creating a more complex decision making process for asset allocation decisions. For example, additional capabilities for incorporating non-traditional asset classes will exist in the future unbundled structure.

GoalMaker (Current Solution)



- The Plans current custom multi-asset class funds are branded "GoalMaker", which are a pre-determined mix of asset classes for each age band.
- Currently, the Board is responsible for asset allocation decisions between asset classes (stable value, fixed income, large cap, etc.)
- Under the future structure, the Board would direct the goals, risk profile and acceptable asset classes for each age band, but outsource the asset allocation decisions to an ERISA 3(38) investment manager.

## RECOMMENDATION #4:

### CUSTOM MULTI-ASSET CLASS PORTFOLIO CONSTRUCTION (CONT.)

#### Recommendation: Board Outsources Responsibility for Custom Multi-Asset Class Portfolio Construction

- **Liability Considerations:** A delegated ERISA 3(38) manager over custom multi-asset class portfolios reduces liability for North Carolina and provides clarity for responsibility of asset allocation decisions.
  - A more thoughtful approach to asset allocation, coupled with daily compliance oversight of each portfolio's asset allocation, will benefit SRP participants through potentially improved performance and enhanced risk controls.
  - The ERISA 3(38) investment manager will assume responsibility for daily management of the portfolios, including strategic manager weights, rebalancing, and tactical portfolio tilts (if permitted).
  - The investment policy should be reconfigured to acknowledge the purpose of these funds and outline specific investment objectives and benchmarks, including how the ERISA 3(38) investment manager's relative outperformance and underperformance will be measured.
- **Cost:** The cost for delegating this responsibility is embedded within Mercer's fee proposal. In addition, SRP staff, investment committee, and Board time will be required to oversee the ERISA 3(38) investment manager's performance for these funds. It should be noted, however, that that Board, Investment Committee and SRP staff will realize time savings as a result of delegating the daily management of the custom multi-asset class portfolios relative to an environment where responsibility for asset allocation decisions is maintained.

## RECOMMENDATION #4:

### CUSTOM MULTI-ASSET CLASS PORTFOLIO CONSTRUCTION (CONT.)

#### Recommendation: Board Outsources Responsibility for Custom Multi-Asset Class Portfolio Construction

- **Critical Success Factors:** The following critical success factors have been identified for outsourcing the responsibility of custom multi-asset class portfolio construction to an ERISA 3(38) investment manager:
  - Similar to the NCSRP White Label Funds, a consistent monitoring process for the ERISA 3(38) investment manager's performance and ability to customize the asset allocation to meet SRP's requirements should be reviewed at least annually.
  - As a manager to the Plans' assets, the ERISA 3(38) investment manager's performance needs to be monitored over time and, if warranted, could be terminated as manager of the custom multi-asset class funds if performance is not meeting expectations.
  - With the unbundling of the Plans, it is anticipated there will be more flexibility to incorporate both traditional and non-traditional asset classes. As such, the entire custom multi-asset class portfolios should be revisited with SRP specific characteristics taken into account such as participant risk tolerance, average account balance, accrued pension benefit, savings rates and a "to" versus "through" retirement analysis for the asset allocation methodology.

## RECOMMENDATION #5: INVESTMENT MANAGER CONTRACTING & EXECUTION

### Recommendation: Board Retains Manager Contracting & Execution and Delegates to SRP Legal

- **Rationale:** The current legal staff for SRP has experience with current investment manager contracts through past collaboration with Prudential. North Carolina will benefit from maintaining this function to control contract provisions, negotiate terms in the best interest of SRP participants, and to lower long-term costs.
- **Liability Considerations:** There is lower liability due to specialized internal legal staff that have familiarity with the Plans' goals and objectives, operational requirements and investment requirements.
  - Within the current bundled arrangement, Prudential has responsibility for structuring and executing manager contracts; however, over time SRP legal staff has taken on more responsibility in this area and it is anticipated to be a relatively seamless transition for reconstructing these agreements within the unbundled structure.
  - Internal contracting and legal resources at Mercer can be leveraged to provide additional review of these contracts.

## RECOMMENDATION #5: INVESTMENT MANAGER CONTRACTING & EXECUTION (CONT.)

### Recommendation: Board Retains Manager Contracting & Execution and Delegates to SRP Legal

- **Cost:** The cost for retaining manager contracting and executing is internal legal staff time and, potentially, additional part-time staff to assist during the contract renegotiation process associated with unbundling Prudential's services.
  - To support current staff and limit part-time resources, Mercer has proposed that North Carolina leverage their internal contracting and legal department. The cost for this support is embedded within Mercer's fee proposal.
  - Additional legal resources during the contract renegotiation process (hourly contract costs) are estimated to be \$40,000 to \$80,000.
- **Critical Success Factors:** The following critical success factors have been identified for manager contracting and execution:
  - Ability to maintain current dedicated internal legal effort with knowledge of manager contracting and executing agreements.
  - SRP staff will be responsible for structuring a process that leverages IMD, Mercer and their own contacts to negotiate investment management terms for existing and new contracts.
    - It was originally contemplated that investment management fees could be lower if Mercer was engaged in a fully delegated arrangement and given authority to sign contracts on behalf of the Plans; however, Slocum has concluded that an SRP staff led effort with collaboration with Mercer and IMD can be just as effective for manager fee negotiations and, as a result, the plans should not be in a disadvantaged position from this perspective.
  - SRP staff will be responsible for working with Mercer and IMD (if necessary) to structure and negotiate investment manager guidelines. Modifications to manager guidelines should be handled by SRP staff with assistance from IMD and Mercer.
  - Maintain current processes and procedures for periodic review of contract provisions relative to current investment policy.

## RECOMMENDATION #6:

### DAILY OPERATIONAL COMPLIANCE MONITORING AND ISSUE RESOLUTION

#### Recommendation: Board Delegates Responsibility for Daily Operational Compliance Monitoring & Issue Resolution to SRP Staff and Mercer

- **Rationale:** Due to the Plans' separate account manager structure and size, it is recommended that the Plans move to daily compliance oversight to identify issues and, more importantly, resolve these issues in a timely manner.
- **Liability Considerations:** Currently, Mercer is overseeing compliance feeds from multiple sources (Prudential, Galliard, JPMorgan, and State Street) and these findings are reported quarterly to the Board, resulting in a complex process that is not “real-time”. With the unbundling of Prudential's contract, an opportunity exists to create one automated feed through the Plans' custodian.

Slocum recommends the following process for monitoring and correcting compliance issues:

- The Board delegates responsibility to SRP staff and Mercer to monitor the Plans' investment managers on a daily basis for compliance with guidelines and portfolio exposures. In the event of compliance breaches, SRP staff will work with Mercer to direct the appropriate managers to correct compliance issues as they arise. Mercer should be given authority to initiate corrective solutions on behalf of the Plans and work directly with the managers under SRP staff supervision.
  - While North Carolina will still “own” and execute investment management agreements, each agreement will be structured to allow Mercer to transact on behalf of North Carolina to resolve compliance related issues. The specific agreement is known as a “Tripartite Investment Management Agreement”. SRP legal has reviewed a template Tripartite Investment Management Agreement and concluded that North Carolina could work under this arrangement with a few required changes to the agreement.

## RECOMMENDATION #6:

### DAILY OPERATIONAL COMPLIANCE MONITORING AND ISSUE RESOLUTION (CONT.)

#### Recommendation: Board Delegates Responsibility for Daily Operational Compliance Monitoring & Issue Resolution to SRP Staff and Mercer

- **Cost:** The cost of daily operational compliance monitoring and issue resolution is SRP staff and Mercer time and resources. These activities are covered in Mercer's fee proposal to North Carolina. It is also anticipated that the additional IMD staff member will oversee this process.
- **Critical Success Factors:** The following critical success factors have been identified for manager daily operational compliance monitoring and issue resolution:
  - Tripartite investment management agreements must be executed to provide Mercer with authority to execute compliance resolution solutions on behalf of the Plans. As mentioned previously, SRP legal has reviewed a sample Tripartite Investment Management Agreement and concluded that North Carolina could work under this arrangement with minimal required changes.
  - Daily processes and procedures must be in place for monitoring compliance breaches. Typically, the appropriate guidelines are set up with the custodian, and the responsible parties (SRP staff and Mercer) are notified as issues arise.
  - SRP staff and Mercer must be provided the proper authority to act on behalf of the Plans. Slow response time to resolve issues does not serve participants well and potentially exposes North Carolina to additional liability.

## RECOMMENDATION #7: PERFORMANCE AND COMPLIANCE REPORTING

### Recommendation: Board Outsources Performance and Compliance Reporting to Mercer

- **Rationale:** Performance and compliance monitoring services are a core competency for Mercer. A comprehensive performance and compliance reporting system would be costly for North Carolina to install, update and maintain on an ongoing basis.
- **Liability Considerations:** Liability slightly decreases by outsourcing to a third party with built in systems to calculate performance and work directly with the Plans' custodian to reconcile discrepancies.
- **Cost:** The cost for performance reporting and compliance monitoring is embedded within Mercer's fees.
- **Critical Success Factors:** The following critical success factors have been identified for performance and compliance monitoring:
  - Clear and comprehensive reporting from Mercer and the Custodian.
  - Regularly scheduled Board meetings to review performance and compliance for the Plans.
  - Monthly performance reporting reviewed by SRP staff with reporting supplied by Mercer.
  - Board and SRP staff must independently assess Mercer as an investment manager to the NCSRP White Label Funds and custom multi-asset class funds.



# MERCER'S FEE PROPOSAL

- Mercer's original fee proposal was based on a fully delegated solution.
- The table below outlines Slocum's recommendation for Mercer's role:

ERISA 3(21) Responsibilities	Hybrid/Shared Responsibility between North Carolina and Mercer	ERISA 3(38) Responsibilities (excludes stable value)
<ul style="list-style-type: none"><li>• Investment policy support</li><li>• Manger selection, monitoring and termination advisory services</li><li>• Investment management agreement assistance and fee negotiation assistance for SRP</li><li>• Daily compliance monitoring</li><li>• Quarterly performance and compliance reporting to the Board</li><li>• Investment consultant for North Carolina's 403(b) Plan</li></ul>	<ul style="list-style-type: none"><li>• Direct managers for compliance trade rectification on behalf of the Plans</li></ul>	<ul style="list-style-type: none"><li>• NCSRP White Label Fund construction and compliance monitoring (SRP Assets = \$6.4 billion)</li><li>• Custom multi-asset class (currently "GoalMaker") portfolio construction and compliance monitoring (SRP Assets = \$3.5 billion)</li></ul>

# MERCER'S FEE PROPOSAL

- Mercer's fee schedule

- Combined ERISA 3(21) and 3(38) Services, based on plan assets excluding stable value (\$6.4 billion).

From	To	Fee Charged
\$0	\$1 Billion	0.04%
\$1 Billion	\$4 Billion	0.03%
\$4 Billion	\$7 Billion	0.02%
Over \$7 Billion		0.01%

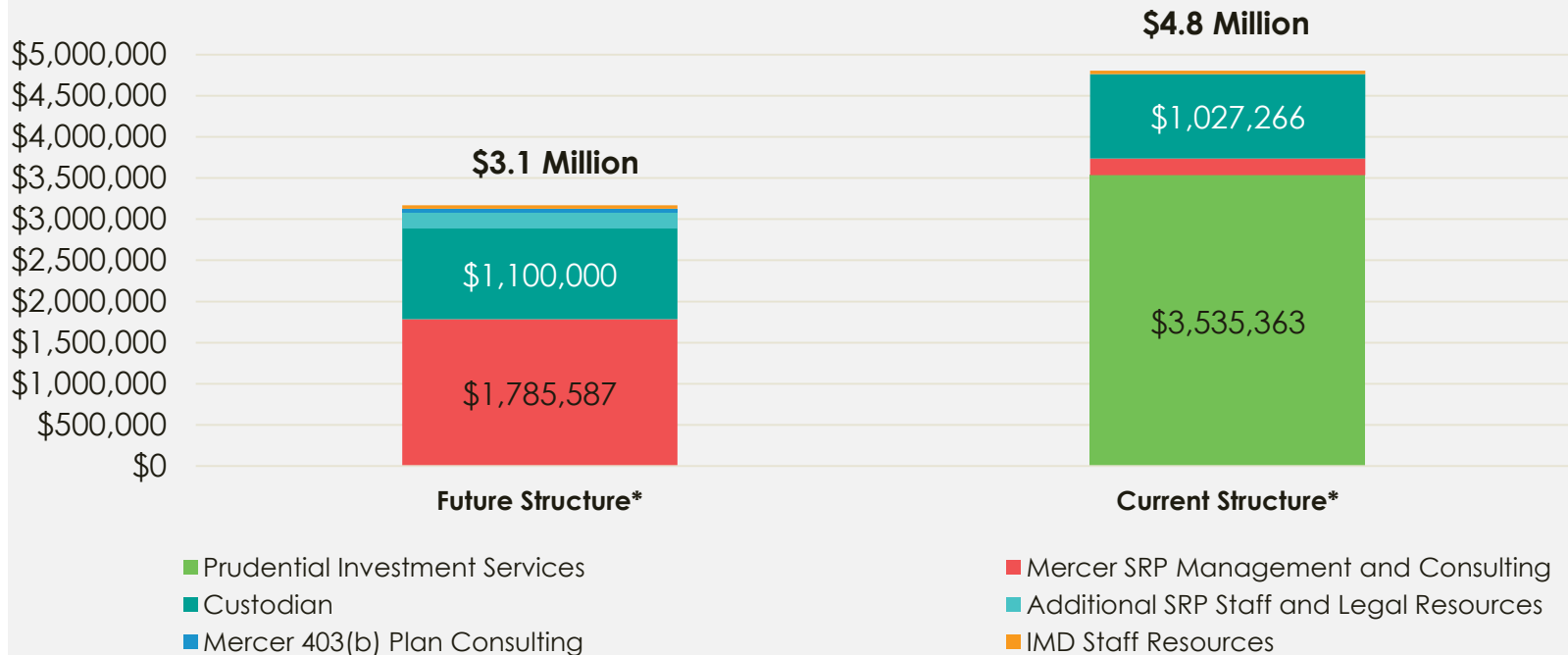
Asset Weighted fee = 2.8 basis points,  
or ~\$1.8 Million based on assets as of  
9/30/14

- Mercer's fee schedule is based on a fully delegated model (assuming all responsibilities performed under a delegated ERISA 3(38) capacity) and not a hybrid structure model.
  - Mercer has not offered a lower fee for the "hybrid approach" recommended by Slocum. Slocum recommends that North Carolina discuss the "hybrid approach", if approved, with Mercer to explore alternative fee structures.
- Mercer will also perform ERISA 3(21) consulting services for the 403(b) Plan. The proposed fee for these services is \$40,000.

# PROGRAM COST COMPARISON

## ■ Current vs. Future Structure Cost Comparison (assumes Mercer's original fee proposal)

- The Supplemental Retirement Plans are expected to benefit from a **cost savings of approximately \$1.7 million, or 35%, under the new investment governance structure**. These fee savings will directly benefit the Plans while enhancing the quality of custom portfolio construction, compliance monitoring and overall governance structure. Further fee savings could be realized after exploring alternative fee structures with Mercer for the "hybrid approach".
- For the future structure, the costs assume a constant budget for IMD resources (at least for the short-term)
- The investment services provided by Prudential will be undertaken by SRP staff, the custodian, and Mercer in the future state due to unbundling the structure. **Prudential's fees outlined below do not include fees for administration.**



## APPENDIX – RESPONSIBILITY MATRIX

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# CURRENT VS. FUTURE STRUCTURE COMPARISON (EXCLUDING GALLIARD)

## Key Responsibilities:

**Develop (D)** = Create materials and obtain information

**Advise (A)** = Use information to provide insight and analysis

**Endorse (E)** = Provide recommendation for proper course of action

**Informed (I)** = Provided information related to that step. Action may or may not be required

**Responsible (R)** = Final approval or responsible for completion

## CURRENT STRUCTURE

	Board	Investment Committee	Counsel	SRP Staff	IMD	Mercer	Prudential
<b>Investments Excluding Galliard 3(38) Portfolio</b>							
Plan Investment Structure	R	E	A	D	A	D	-
Manager Compliance	R	E	-	A	-	D	-
Performance and Compliance Reporting to Board	I	I	-	I	-	R	-
Manager Selection/Termination	R	E	-	A	A	D	-
Manager Search Development and Documentation	I	I	-	I	A	D	-
Manager Monitoring/Evaluation	R	E	-	E	A	D	-
Manager Due Diligence	I	I	-	R	D	D	-
Transition Management (including manager selection)	I	I	-	R	A	D	A
Investment Manager Agreements/Guidelines	I	I	D	D	-	A	D
Fee Negotiations	I	-	-	A	A	A	-
Custom Fund Portfolio Construction (White Label & Target Date)	R	E	-	A	A	D	D
Proxy Voting	I	I	-	R	A	A	-

## FUTURE STRUCTURE

	Board	Investment Committee	Counsel	SRP Staff	IMD	Mercer	Custodian*
<b>Investments Excluding Galliard 3(38) Portfolio</b>							
Plan Investment Structure	R	E	A	D	A	D	-
Manager Compliance	I	I	-	R	A	R	-
Performance and Compliance Reporting to Board	I	I	-	I	I	R	-
Manager Selection/Termination	R	E	-	E	A	D	-
Manager Search Development and Documentation	I	I	-	R	D/A	D/A	-
Manager Monitoring/Evaluation	I	I	-	R	D	D	-
Manager Due Diligence	I	I	-	R	D	D	-
Transition Management (including manager selection)	I	I	-	R	D	D	-
Investment Manager Agreements/Guidelines	I	I	R	R	A	A	-
Fee Negotiations	I	I	-	R	A	A	-
Custom Fund Portfolio Construction (White Label & Target Date)	I	I	-	I	I	R	-
Proxy Voting	I	I	-	R	A	A	-

\*Custodian will assume some of the responsibilities previously performed by Prudential, the current recordkeeper.

# CURRENT STRUCTURE – GALLIARD (UNCHANGED IN FUTURE STATE)

## Key Responsibilities:

**Develop (D)** = Create materials and obtain information

**Advise (A)** = Use information to provide insight and analysis

**Endorse (E)** = Provide recommendation for proper course of action

**Informed (I)** = Provided information related to that step. Action may or may not be required

**Responsible (R)** = Final approval or responsible for completion

	Board	Investment Committee	Counsel	SRP Staff	IMD	Mercer	Galliard	Record-keeper
<b>Stable Value Investments Controlled by Galliard*</b>								
Manager Compliance	I	I	-	I	-	-	R	-
Performance Reporting	I	I	-	I	-	-	R	-
Manager Selection/Termination	I	I	-	I	-	-	R	-
Manager Search	I	I	-	I	-	-	R	-
Manager Monitoring/Evaluation	I	I	-	I	-	-	R	-
Manager Due Diligence	I	I	-	I	-	-	R	-
Transition Management	I	I	-	I	-	-	R	-
Investment Manager Agreements/Guidelines	I	I	-	I	-	-	R	-
Fee Negotiations	I	I	-	I	-	-	R	-

\*Galliard serves as a delegated 3(38) manager over North Carolina's stable value portfolio. The Board, Investment Committee and SRP are still responsible for monitoring Galliard on an ongoing basis.

## CURRENT STRUCTURE – GOVERNANCE, PLAN DESIGN & ADMINISTRATIVE (UNCHANGED IN FUTURE STATE)

### Key Responsibilities:

**Develop (D)** = Create materials and obtain information

**Advise (A)** = Use information to provide insight and analysis

**Endorse (E)** = Provide recommendation for proper course of action

**Informed (I)** = Provided information related to that step. Action may or may not be required

**Responsible (R)** = Final approval or responsible for completion

	Board	Investment Committee	Counsel	SRP Staff	IMD	Mercer	Galliard	Record-keeper
<b>Governance</b>								
Investment Policy Statement	R	E	A	D	A	A	-	-
Governance/Fiduciary Education	I	I	R / D	I	-	-	-	-
Regulatory/Compliance Updates	I	I	R	I	-	-	-	D / A
Service Provider Retention and Termination	R	E	A	D	-	-	-	-
	Board	Investment Committee	Counsel	SRP Staff	IMD	Mercer	Galliard	Record-keeper
<b>Plan Design</b>								
Plan Design Review and Benchmarking	I	I	I	D	-	A	-	-
Plan Design Changes	R	E	A	D	-	A	-	A
DC Trends and Thought Leadership	I	I	I	D	-	A	-	-
Retirement Income Adequacy Analysis	I	I	-	D	-	A	-	D
	Board	Investment Committee	Counsel	SRP Staff	IMD	Mercer	Galliard	Record-keeper
<b>Administrative</b>								
Recordkeeper Service and Fee Evaluation	I	I	-	R	-	D	-	-
Procurement of Vendor Services	R	I	A	D / A	-	-	-	-
Oversight of Vendor Relationships and Performance Guarantees	I	I	A	R	-	D	-	-
Day-to-Day Plan Management	-	-	A	R	-	-	-	-

## APPENDIX - GOVERNANCE CONSIDERATIONS

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## SUMMARY

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- All organizations are different. Dynamics between the Board, internal staff and committees, and consultants are different. In the end, the goal is to ensure that the limited time all three parties are together is effectively used towards strategy and overall direction of the investment portfolios.
- Ultimately, an organization aims to create a governance process and philosophy that maximizes the efficiencies and skills of each group, effectively makes timely decisions, and maximizes each group's time and efforts.
- With that said, there are a few activities that Slocum believes are vitally important for a governing body with fiduciary oversight:
  - ✓ Organizing an effective Board – clearly define roles and responsibilities
  - ✓ Structuring effective use of the Investment Committee – focus on strategy and top level results
  - ✓ Maintaining proper oversight – review risk, returns, and compliance (Fiduciary Duty)
  - ✓ Avoiding conflicts of interest

# ORGANIZING A COMMITTEE

- The chart below shows the Traditional make-up of a committee vs. those deemed to be “Best Practices”, as noted by Yoder.

	Traditional	Best Practices
Board Role	Makes all final decisions. Very hands-on.	Delegates much. Focused largely on big-picture/policy issues
Investment Oversight Role	Filled by Committee/Internal Staff/Consultant	Strong role, filled by internal team with authority to implement policy
Roles, Board tenure, composition, & conflicts of interest	Undefined	Well-defined

# STRUCTURING EFFECTIVE USE OF TIME

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- Boards are typically responsible for strategic decisions and initiatives, relying on the due diligence of service providers and staff to make informed decisions.
- Investment Committees usually meet quarterly to discuss strategic and tactical plan issues.
- With this in mind, tasks involving the implementation of the strategic decisions should be delegated to Management/Staff and the Investment Consultant/OCIO.
- Investment Committee members often have a sense of “losing control” of decisions.
  - This is especially evident in the selection and oversight of investment managers.
  - There is a “Fiduciary gray area” with this sense of lost control.

## GOVERNANCE CONSIDERATIONS - SOURCES

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- Yoder, Jay. *Effective Endowment Management*. CAIS/NYSAIS Business Affairs Conference. 2005.
- Olson, Russell L. *The Handbook for Investment Committee Members*. John Wiley & Sons Inc., 2005.
- Yoder, Jay. *Endowment Management: A Practical Guide*. Association of Governing Boards of Universities and Colleges. 2004.

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