

OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM
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www.opers.org

MEMORANDUM

DATE: July 7, 2006

TO: OPERS Retirement Board Members

FROM: Karen Carraher, Director-Finance
Tom Sherman, Government Relations Officer

RE: **V. Discussion Items:**
A. Custody Update

Purpose – To update Board members as to recent discussions with the Treasurer of State’s staff regarding custody.

Background – Staff provided the Board with an update regarding the status of the custody designation at the May Board meeting. A copy of that memo is attached. Please see that memo for some historical detail of the events surrounding the custody issue.

OPERS staff met with Pat McDonald, Deputy Treasurer on July 6, 2006 at his request. The purpose of the meeting was to seek clarification and understanding as to OPERS’ issues and concerns with custody of both the domestic and international portfolios. Currently, JP Morgan, as a result of their merger with Bank One, serves as the custodian of OPERS’ domestic assets while State Street serves as the custodian of OPERS’ international assets.

In accordance with state statute, the Treasurer of State is designated as the custodian of the funds of OPERS with the authority to enter into sub-custody agreements to execute its custodial duties required by law. However, the Treasurer of State does not have any authority regarding the decision-making on the investment of funds, as the OPERS Board retains the full funds investment authority. The Treasurer recently re-designated JP Morgan as the depository for OPERS, but to date has deferred the designation of custodian(s).

By way of background, prior to the Bank One/JP Morgan/Chase merger, which was announced in January 2004, Bank One was unable to custody international assets. OPERS as well as the other Ohio retirement systems needed access to a top-tier custodian that offered full-scale custodial services. Thus, the dual custodian structure of an Ohio bank for domestic custody and a top-tier institution for international custody was developed. Bank One's merger with JP Morgan/Chase provides them with this ability to serve as a top-tier custodian.

The development of the DC plans in 2002 added additional complexity to this structure, just as the implementation of the HCPP will add an additional layer of complexity to the structure. In conjunction with the implementation of the DC plan, OPERS conducted a search process for a DC fund accountant. OPERS was able to garner enhanced services and reduced costs by bundling the global custody services and fund accounting services. The Treasurer of State supported this structure by designating State Street as the global custodian.

Currently, CitiStreet serves as the Third Party Administrator of the DC plan while State Street serves as the fund accountant. State Street, as the fund accountant, strikes a daily net asset value (NAV) for the DC portfolio investments. State Street has the infrastructure in place with CitiStreet to facilitate timely and accurate delivery of the NAV. CitiStreet has also been selected to serve as the conduit with Aetna for the RMA accounts established under the HCPP and the Member-Directed Plan.

OPERS staff summarized the System and the Board's concerns and committed to provide Mr. McDonald with a written summary of these issues to assist in his evaluation. Mr. McDonald indicated that he understood that most of the Board was not in opposition to a change in international custodian from State Street to JP Morgan. Staff indicated that this was not our understanding of the general direction of the Board. Mr. McDonald indicated that the Treasurer would be making a decision within the next couple of weeks as to the next steps for designating a custodian, which could include the issuance of an RFP, an appointment of a new custodian or leaving the current custody designation in place.

Issues: The main issues of concern OPERS raised regarding a change in custodian and especially a rapid unplanned change are:

- Changing custodians should have an upside benefit such as reduced cost or improved functionality to compensate for conversion costs and risks to OPERS.
- Conversion risks include operational risk to the System, risk of incorrect investment accounting data and lost revenue from the suspension or moderations of securities lending.

- The timing of any conversion must be well planned and must also allow adequate time for testing and review without the imposition of an arbitrary and short implementation timeline.
- The process should involve an open and competitive bid evaluation to ensure that the institution ultimately selected to provide any services is the best-qualified provider of such services.
- As OPERS continues to grow in complexity and as service demands increase, any potential change must be carefully evaluated and planned for in terms of the impact on current operations and associated risk.
- Bid processes should be coordinated to evaluate master record keeping and fund accounting in conjunction with custody.
- OPERS has invested considerable time and capital in developing an infrastructure. Once a structure and relationship is established, designations and changes should occur in intervals to allow adequate recoupment of costs.
- OPERS believes that fees could be substantially reduced if the custodian factored in all services it provides to OPERS.

Next Steps: As a follow-up to the meeting with Mr. McDonald, OPERS staff will prepare a letter summarizing the Board and System's concerns regarding a change in custodian. A copy of the letter, while not available at the time of this memo, will be distributed to the Board. As indicated above, the Treasurer's staff indicated that a decision as to the international custodian would be forthcoming. OPERS staff will keep the Board informed as to the status.

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MEMORANDUM

DATE: May 2, 2006

TO: OPERS Retirement Board Members

FROM: Karen Carraher, Director-Finance
Julie Becker, General Counsel

RE: Custody Update

Purpose – To provide all Board members with background information and a current status update as to the custodian issues in response to questions asked during last month's Board meeting.

Background – Under state statute, the Treasurer of State is designated as the custodian of the funds of OPERS. Specifically, the custodial duties include:

- Safekeeping of the custodial funds and investment assets of the OPERS Board,
- Collecting principal, dividends, distributions, and interest on custodial funds and investment assets of the OPERS Board as they become due and payable and placing them when collected into custodial funds,
- Paying for investments purchased by the OPERS Board on receipt of written or electronic instructions by the Board or the Board's designated agent authorizing the purchase and pending receipt of evidence of title of the investment by the Treasurer of State's authorized agent,
- Accepting payment from the purchaser of OPERS investments and delivering evidence of title of the investment to the purchaser on receipt of written or electronic instructions from the OPERS Board or the OPERS Board's designated agent authorizing the sale, and pending receipt of the moneys for the investments, and placing the amount received in custodial funds.

As the custodian, the Treasurer of State has the authority to enter into sub-custody agreements to execute its custodial duties required by law and thus designates custodians for the retirement systems. However, the Treasurer of State does not have any authority regarding the decision-making on the investment of funds, as the OPERS Board retains the full authority to invest the OPERS funds.

State statute authorizes the State Board of Deposit with the authority to designate the depositories of the public moneys of the state. The State Board of Deposit is comprised of the Treasurer of State, the Auditor of State and the Attorney General or their designees. In the past, the Treasurer has recommended the depository and custodian to the Board of Deposits, who ultimately authorizes the final decision. Prior to the latest designation in March 2006, the Treasurer clarified that the Board of Deposit's responsibility is to designate the depository and the Treasurer has the authority independent of the Board of Deposit to designate a custodian. Thus, the last bi-annual designation occurred in March 2006 and the Board of Deposits re-designated Bank One/JPMorgan/Chase as OPERS' depository.

Currently, the Treasurer has designated Bank One as the custodian for domestic assets and State Street as the custodian for international assets for OPERS. Until the recent merger with JPMorgan/Chase, Bank One had been unable to custody international assets. State Street also serves as master record keeper. In addition, OPERS uses State Street as the fund accountant for the DC plan accounting. A fund accountant is used to strike daily net asset values for the DC plan. The master record keeper is used to aggregate OPERS' total portfolio for purposes of monitoring total portfolio compliance, performance, risk, etc. OPERS retains the right to determine the master record keeper and fund accountant.

This structure was put into place when the DC plan was created in 2002 and a search was conducted for a DC fund accountant. During the search process for the DC fund accountant, OPERS was able to garner enhanced services and reduced costs by bundling the global custody services and fund accounting services. The Treasurer of State, who serves as the custodian of the System's funds, supported this structure. Since the implementation of the DC plan, OPERS has added additional functionality and complexity to the structure.

During 2003, OPERS initiated an investment accounting operations review. The purpose of this project was to streamline investment accounting operations, delineate roles and responsibilities, maximize efficiencies, improve service levels, and address issues unique to OPERS for all entities associated with OPERS investment operations. OPERS evaluated options in an effort to develop a model that meets our needs as well as industry-wide best practice standards. As a result of the project, OPERS developed a blueprint for a complete infrastructure revision centered on creating a data repository in which the OPERS detailed

transaction level investment data is stored. Essentially, this data repository will make critical investment information available to all the multiple users of the information in a variety of formats. The centralization of the data eliminates the likelihood of errors due to the existence of multiple data centers, but more importantly it reduces OPERS' reliance on outside institutions. The increased self-reliance that OPERS would gain from the data repository removes many of the operational risks and service deficiencies we would otherwise face because of OPERS' lack of control over the selection of its custodians. The design of the data repository allows various components of the operating structure (such as managers) to be replaced with significantly reduced risk to the overall structure.

Throughout the process, OPERS staff has shared this blueprint, corresponding plans and timelines in several meetings with representatives from the Treasurer's office and gained their support. Given that the investment accounting system was due for replacement/upgrade during fiscal year 2005, the new infrastructure was targeted to be in place by mid-2006. This project was completed last month for domestic assets and is scheduled to be completed for international assets by June 30.

Prior to the Bank One/JP Morgan/Chase merger, which was announced in January 2004, Bank One was unable to custody international assets. The merger with JP Morgan/Chase provided them with this ability. OPERS staff had discussed this with the Treasurer's representatives during the last custodian re-designation (July 2004). Both staffs agreed that this option would likely be evaluated in the next custodian re-designation (July 2006) after the merger was completed and operational and transitional merger issues were totally resolved.

In October 2004, the Deputy Treasurer informed OPERS of the Treasurer's (at that time the Treasurer was Mr. Deters) interest in changing global custodians from State Street to JP Morgan on an accelerated and compressed time schedule prior to the usual re-designation period due to normally occur in March through July 2006. When OPERS questioned this fast pace, the Deputy Treasurer agreed that a thorough evaluation and assessment was needed.

The main issues of concern OPERS raised regarding a change in custodian and especially a rapid unplanned change were:

- Changing custodians should have an upside benefit such as reduced cost or improved functionality to compensate for conversion costs and risks to OPERS.
- Conversion risks include operational risk to the System, risk of incorrect investment accounting data and lost revenue from the suspension or moderations of securities lending,

- The timing of any conversion needs to be well planned and allow adequate time for testing and review without the imposition of an arbitrary and short implementation timeline.
- The process should involve an open and competitive bid evaluation to ensure that any institution ultimately selected to provide any services is the best-qualified provider of services.
- As OPERS continued to grow in complexity and the service demands increase, any potential change needs to be carefully evaluated and planned for the impact on current operations and associated risk.
- Bid processes should be coordinated to evaluate master record keeping and fund accounting in conjunction with custody.
- OPERS has invested considerable time and capital in developing an infrastructure. Once a structure and relationship is established, designations and changes should occur in intervals to allow adequate recoupment of costs.
- OPERS has a fiduciary responsibility to analyze the total impact of overall fees associated with any significant change. Fees should be determined relative to OPERS' size and services needed and not based on the overall needs of the state. OPERS believes that fees could be substantially reduced if the fees factored in OPERS asset base and the other services OPERS receives from the institution.

Since that time, OPERS staff, the Treasurer's staff and JP Morgan/Chase staff have met to discuss issues and gain an understanding of OPERS' current environment and potential obstacles and risks. In March 2005, Treasurer Bradley sent a letter to OPERS indicating that she had reviewed the prior administration's decision to change the international custody relationship from State Street to JP Morgan/Chase.

OPERS expected this decision to be re-visited during the 2006 bi-annual re-designation; however, as mentioned previously, the custody decision was separated from the depository designation. OPERS staff have met with the Treasurer's staff and reviewed issues and needs in consideration of the development of a formal Request for Proposal. OPERS staff have inquired as to the timeframe and process for the designation of a custodian. To date, we are unclear as to the timeframe other than it appears that it may not occur until after the November 2006 election. OPERS staff are unclear as to the process and the criteria for the designation.

Issues: The Board has requested a legal opinion on the Board's fiduciary responsibility relative to any decisions that may incur additional costs for the System. Additionally, the Board requested guidance on its fiduciary responsibility in seeking legislation to change the current statute, if the Board determines that is in its best interest. The Board also requested feedback from EKA as to whether the current relationship costs OPERS more and if OPERS has access to the services it needs.

Next Steps: Fiduciary counsel and the Board's investment advisor, EK&A, will be at the next Board meeting to address the Board's questions.