



THE HONORABLE CURTIS M. LOFTIS, JR.
State Treasurer

January 6, 2014

Ms. Marcia Adams
Executive Director, Budget & Control Board
6th Floor Wade Hampton Office Building
Columbia, South Carolina

Mr. David Avant
Executive Director, Public Employee Benefit Authority
Post Office Box 11960
Columbia, SC 29211-1960

Mr. Greg Ryberg
Interim Chief Operating Officer, Retirement System Investment Commission
1201 Main Street, Ste. 1510
Columbia, SC 29201

Dear Ms. Adams and Messrs. Avant and Ryberg:

On December 30, 2013 the State Treasurer's Office and Bank of New York Mellon entered into a custodial agreement that became effective January 1, 2014. Please find enclosed a copy of that agreement and a document that details the enhanced security, reporting, fee and training concessions, and additional transparency and accountability provided to protect the assets valued at approximately \$40.3 billion dollars.

A custody agreement with a large global custodial bank is necessary in today's investing environment and is required for the State's Funds (approximately \$ billion) and Trust Funds (approximately 4 billion). Under the agreement, BNY Mellon will perform critical services such as: safekeeping of the assets held by the Bank, trade processing, cross-border settlements, income collection, cash processing, tax reclaims, and regulatory reporting. The Bank is now mandated to do consolidated accounting and reporting of the 61% of the Trust Fund assets that are not held in custody by the Bank. Please note, however, that the State Treasurer's Office, nor the Bank, can guarantee the existence, safety, accuracy of reporting, or calculations of the out-of-bank assets.

Our goal was to take personalities and politics out of the decision-making process of competitively bidding the State's custody work. In consultation with the State's Procurement Office, a request for proposal from custodial banks, an advisory panel consisting of employees of the State Treasurer's Office, the Retirement System Investment Commission, and the Public Employee Benefit Authority gave a thorough review of the submitted bids. In May 2012, the advisory panel and the State Treasurer's Office pension consultant recommended that the State Treasurer's Office negotiate a custody contract with the Bank of New York Mellon. BNY Mellon is the largest custody bank in the world with

\$27.7 trillion in assets under custody and administration. BNY Mellon has served as the state's custodial agent under seven treasurers and for over 30 years without ever a lapse in contract or service.

The custody agreement was last renewed by the State Treasurer's office in 2007 and had no ending date. Under the new ten year agreement that has a termination clause, BNY Mellon will continue to serve as the custodial agent for the approximately \$12.7 billion managed by the State Treasurer's Office ("State Funds"), including the State's General Fund, the State Investment Pool, the Insurance Reserve Fund, the Education Improvement Act, the S.C. Tuition Prepayment Fund, and the Local Government Investment Pool and for the \$27.6 billion invested on behalf of the five South Carolina retirement systems ("Trust Funds").

In the 2007 agreement, BNY Mellon took a 15% share of all securities lending earned by State Funds and Trust Funds in lieu of paying specific or invoiced custody fees. Under this financial arrangement, the State often spent paid far in excess of annual custodial costs. In 2009, the then-Chief Investment Officer of the Retirement System Investment Commission said, "*Since 2005, [we have] basically paid \$5 million more than [we] should have for custody and other services provided by BNY Mellon...I would recommend that [we]...modify the securities lending revenue sharing agreement with BNY Mellon to align the payment for cost of services received.*" Please note that in the updated agreement, South Carolina will receive 90% of all securities lending earned by the Funds.

No custodial banks submitting proposals, including BNY Mellon, were willing to waive custodial fees in lieu of taking a larger share of securities lending revenues. Under the new agreement, State Funds and Trust Funds will continue to pay custodial fees from securities lending income after receiving a quarterly invoice that identifies custodial fees charged by the Bank. The fees will be paid directly from the applicable Fund.

The fixed annual custodial fees, the variable global asset fees, and variable global transaction fees related to the Trust Funds will be paid by Trust Fund's share of securities lending revenues, which is currently more than sufficient to pay these costs. This method of directly paying custodial fees increases transparency and accountability in both the State's general fund and in the retirement system. This direct payment of custodial fees prevents the possible overpayment of custody fees, as had been the case in previous years.

It should be noted that, as in prior years, revenues from securities lending have never been unlimited, and are affected by various factors. Fiduciaries must make alternative payment plans prior to, or contemporaneous with, investment decisions that may terminate or diminish certain securities lending activities or increase variable fees beyond a certain point in order to ensure that the Trust Funds receive the necessary support of a global institutional custodial agent.

I am thankful for the assistance provided from the State Procurement Office and for the staff from the State Treasurer's Office, RSIC, and PEBA who served on the procurement advisory panel and all those others who provided input and support as on our new agreement.

Sincerely,



Curtis M. Loftis, Jr.
State Treasurer

Enclosures