SYNOPSIS OF THE MINUTES OF THE
LEGISLATIVE JOINT AUDITING COMMITTEE
SEPTEMBER 17, 2012

REPORTS PRESENTED

- Financial Audit – Treasurer of State – Year Ended June 30, 2011
- Special Report – Review of Selected Bond Investment Transactions – Arkansas State Treasury
- Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices

NEW BUSINESS

The Committee approved a request for an audit of Connect Arkansas.

FUTURE MEETINGS OF THE LEGISLATIVE JOINT AUDITING COMMITTEE

The next meetings will be held on Thursday and Friday, October 11 and 12, 2012, unless called by the Co-Chairs.

MINUTES OF THE MEETING OF THE
LEGISLATIVE JOINT AUDITING COMMITTEE
SEPTEMBER 17, 2012

The meeting was called to order by Co-Chair Senator Bill Pritchard at 2 p.m., Monday, September 17, 2012, in Committee Room B, MAC Building, Little Rock, Arkansas.

The following members were present: Co-Chair Senator Bill Pritchard and Co-Chair Representative Tim Summers; Senators Cecile Bledsoe, Linda Chesterfield, Jonathan Dismang, Stephanie Flowers, Johnny Key, Jason Rapert, Bill Sample, and Eddie Joe Williams; Representatives Fred Allen, Duncan Baird, Nate Bell, Toni Bradford, David Branscum, John Burris, Les Carnine, John Catlett, Robert Dale, Jane English, Jeremy Gillam, Kim Hammer, Justin Harris, Mary P. "Prissy" Hickerson, Karen Hopper, Andrea Lea, Kelley Linck, Buddy Lovell, Loy Mauch, Andy Mayberry, Walls McCrary, Stephen Meeks, Jim Nickels, Mike Patterson, James Ratliff, Terry Rice, Mary L. Slinkard, Jeff Wardlaw, Jon Woods, and Tommy Wren.

The following guests were present: from the Treasurer of State's Office: Martha Shoffner, Treasurer of State; Debbie Rogers, Chief Deputy Treasurer; Autumn Sanson, Chief Investment Officer; and Melissa Corrigan, Chief Financial Officer; from the Arkansas Securities Department: A. Heath Abshure, Commissioner; from the Department of Finance and Administration: Richard Weiss, Director, and Ricky Quattlebaum, Internal Auditor; from St. Bernard Financial Services: Robert Keenan; from Mullenix and Associates: Ted Mullinex, President, and Julie Mullinex, Legal Counsel; Joe Jhett and Jack Critcher, citizens.

REVIEW OF REPORTS
Financial Audit – Treasurer of State – Year Ended June 30, 2011

Co-Chair Senator Pritchard explained to the Committee that Deputy Legislative Auditor Jon Moore would present all three reports on the agenda and reminded Committee members to limit their questions to issues raised by the reports.

Mr. Moore presented the following findings from the Financial Audit – Treasurer of State – Year Ended June 30, 2011.

- 2011-1: The Office of Treasurer of State (Treasury) understated prepaid expenses by $2,271 and accounts payable by $9,932. Although immaterial to the financial statements of the general fund, Division of Legislative Audit (DLA) staff consider these errors qualitatively significant since these are the only accrual amounts calculated by the Treasury. All other accruals were calculated by the Department of Finance and Administration (DFA).

- 2011-2: The equipment records of the Treasury, maintained outside of the Arkansas Administrative Statewide Administrative System (AASIS), do not agree with AASIS. Since AASIS is used as the source of information for the State's CAFR, these errors affect the accuracy of that report. Specifically, Treasury records for equipment total approximately $2.39 million, while the total for equipment maintained in AASIS is $3.02 million, creating a difference of approximately $635,000.

Financial Audit – Treasurer of State – Year Ended June 30, 2011 (continued)

- 2011-3: The Arkansas State Treasury Investment Policy requires that each securities firm approved by the Treasurer submit "semiannual and annual reports, including audited financial statements…." DLA staff asked to review these documents and were told that the Treasury did not have them.

- 2011-4: Subsequent to June 30, 2011, the Treasury sold bonds from its investment portfolio to selected bond brokers before the bonds reached maturity and subsequently purchased similar bonds from the same investment brokers, resulting in a net economic loss of $58,172. This practice differs from the Treasury's previous practice of holding bonds until maturity. Furthermore, in November 2011, DLA staff advised the Treasury that Generally Accepted Accounting Principles (GAAP) require gains and losses on the sale of these bonds to be recorded separately from interest income. The DFA - Office of Accounting agreed with the applicability of these accounting principles. However, the Treasury did not record these transactions as advised. These transactions, as well as the Arkansas State Treasury Investment Policy, are the subject of two separate reports issued concurrently with this report.

Special Report – Review of Selected Bond Investment Transactions – Arkansas State Treasury

Mr. Moore presented the Special Report – Review of Selected Bond Investment Transactions – Arkansas State Treasury in response to questioned transactions identified during the Arkansas State Treasury financial audit for the fiscal year ended June 30, 2011. The Treasury changed its investment practice of holding bonds until the call or maturity date and began selling the bonds to certain brokers earlier than required.

The objective of the report was to review questioned bond transactions identified in the Treasury's fiscal year 2011 financial audit to disclose the financial effects of selling these bonds prior to maturity. The investment transactions reviewed in this report occurred from July 1, 2011 to May 17, 2012. Division of Legislative Audit (DLA) staff obtained supporting documentation and information for each transaction and calculated the economic effects of these transactions.

The Arkansas State Treasurer is an executive officer of the State, established by the Constitution of the State of Arkansas, and is to perform all duties required by Arkansas Code. The Treasurer is charged with serving as the custodian of monies required by Arkansas Code to be held in the Treasury, which totaled $3.27 billion in state and federal funds at June 30, 2011. As investor of state and federal funds, the Treasurer, pursuant to Ark. Code Ann. § 19-3-518, is authorized to invest Treasury funds in the manner prescribed by the Arkansas State Treasury Investment Policy, which is approved by the State Board of Finance.

As noted in the Treasury's 2011 financial audit report, the Treasury sold bonds back to brokers before they were called or reached their maturity dates, purchased similar bonds from the same brokers, and then repeated this sell/purchase activity. Historically, the Treasury has held investments to the call or maturity dates, and the Treasury Investment Policy does not allow for speculation on future rates of return or call dates. In addition, DLA staff noted that a significant portion of Treasury bond purchases were made from a single broker.

Special Report – Review of Selected Bond Investment Transactions – Arkansas State Treasury (continued)

According to records obtained from the Treasury on May 17, 2012, 12 bond sale transactions were completed between July 1, 2011 and May 17, 2012. During this time, the Treasury sold these 12 bonds valued at over $240 million and replaced them with similar bonds, resulting in an economic net loss of $58,172. The loss could have been avoided had the Treasury continued to hold the original bonds until they were called by the bond issuer. DLA staff were able to obtain information on these sales as well as the replacement bonds that were sold back to the Treasury for 11 of the 12 transactions. See Exhibit I on page 3 of the report for a summary of these transactions.

Three concerns resulted from DLA analysis of these selected transactions. The first concern is that some of the replacement bonds sold to the Treasury had lower rates of return than the bonds originally held. For example, in one of the transactions reviewed, the Treasury sold a bond that paid an interest rate of 2.00% that could have increased to 4.00% and replaced it with a bond that paid a fixed interest rate of 1.50%. Of the 11 bonds reviewed that the Treasury sold to the brokers, 8 were replaced with bonds paying a lower interest rate. While some of the bonds the Treasury sold to the brokers were sold for more than face value, DLA analysis showed the Treasury would have better served the State by holding the original bond to its call date. Holding bonds until they are called or reach their maturity date is also more consistent with the Treasury Investment Policy.

The second concern is that the new investment practices place more funds in money market mutual fund accounts, which pay very low interest rates (currently 0.01%), for extended periods. When the Treasury sells a bond to a broker, the proceeds are placed in a money market mutual fund account until the settlement date of the replacement purchase. In one of the transactions reviewed, a $25 million bond was sold to a broker, and the proceeds remained in a money market mutual fund account for 80 days. During those 80 days, $548 of interest was earned compared to the $91,667 in interest that the original bond would have earned at its 1.65% interest rate. As seen in Exhibit I on page 3, these transactions led to large amounts of money held in money market mutual fund accounts drawing 0.01% in interest for a total of 218 days.

The third concern raised by DLA analysis is how quickly the replacement bonds sold to the Treasury were either called by the bond issuer or sold to a broker, resulting in the Treasury again having to buy more replacement bonds. In 7 of the 11 transactions reviewed, the replacement bonds sold to the Treasury were called or resold to a broker within six months. For the transactions reviewed, DLA staff noted that selected brokers received substantial compensation for selling replacement bonds to the Treasury. Therefore, while participating in these transactions appears to yield no financial gain for the State, such transactions are very attractive to the brokers involved because they create new sales and broker fees.

Since July 1, 2008, the Treasury has purchased a significant proportion of its bonds from an individual broker associated with two different Arkansas securities firms: Apple Tree Investments, Inc. (May 2008 to May 2009), and St. Bernard Financial Services, Inc. (June 2009 to present). DLA staff obtained purchase records from the Treasury for July 1, 2008 to March 31, 2012, and summarized the purchases by firm in Exhibit II on page 4 of the report. During this period, a single firm sold the Treasury $1.69 billion in bonds, with the next largest firm selling the Treasury $886.0 million in bonds.

Special Report – Review of Selected Bond Investment Transactions – Arkansas State Treasury (continued)

In order to determine potential financial benefit of the Treasury's concentrated use of this single firm, DLA staff calculated the dollar value weighted average yield by firm at June 30, 2011, as seen in Exhibit III on page 4 of the report. Based on this analysis, the individual firm with the Treasury's largest amount of purchases did not have the highest dollar value weighted average yield. This firm's dollar value weighted average yield was only 0.02% higher than the fourth and fifth largest yields received. Therefore, no advantage to the Treasury's concentrated use of this one firm was apparent. In addition, the three firms that sold the most bonds to the Treasury for this time period (St. Bernard Financial Services, Inc.; Morgan Keegan & Company, Inc.; and Bank of Oklahoma Investments) are the same firms involved in the transactions discussed in Exhibit I that resulted in the Treasury's economic net loss of $58,172.

The 11 bond transactions summarized in Exhibit I of the report all occurred after June 30, 2011. These transactions resulted in an economic net loss to the State of $58,171.80. Subsequent to the completion of the report, DLA staff became aware that the Treasury had been selling bonds to brokers before the bonds were called or reached their maturity date as far back as fiscal year 2010. A total of 29 bonds were sold from September 8, 2009 to February 6, 2012. DLA staff analyzed the net economic benefit of only one transaction occurring prior to the year ended June 30, 2011. This transaction resulted in an economic net loss to the State of $835,931.55. Subsequent analysis also revealed that St. Bernard Financial Services, Inc., the firm involved in the trade that resulted in this loss, was issued a letter of caution by the Arkansas Securities Department on August 28, 2012, for activities associated with Treasury bond transactions.

Historically, the Treasury has held investments to the call or maturity dates, and the Treasury Investment Policy does not allow for speculation on future rates of return or call dates. However, DLA analysis of bond sale transactions completed between July 1, 2011 and May 17, 2012, indicated several new Treasury practices resulting in economic loss to the State. These included exchanging bonds for lower rates of return, holding funds in accounts paying lower interest rates, completing frequent bond transactions, and purchasing a significant proportion of bonds from a single broker.

DLA staff recommend the Treasury consult a third party money manager regarding investment purchase decisions and obtain input from the State Board of Finance before changing significant investment practices. Management response is provided in Appendix A on page A-1 and in Appendix B of the September 2012 report titled "Review of State Board of Finance Investment Policy and Arkansas State Treasury Investment Practices."

Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices

Mr. Moore presented the Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices in response to investment policy and practices identified during the Arkansas State Treasury financial audit for the fiscal year ended June 30, 2011.

Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices (continued)

The Treasurer is charged with serving as the custodian of monies as required by Arkansas Code. Historically, the Treasurer has also been responsible for making specific investment decisions associated with state funds held in excess of immediate needs. Changes in the overall investment environment have made it increasingly difficult to maintain adequate safety, liquidity, and return on investment. The rate of return on the Arkansas State Treasury investment portfolio has decreased steadily over the last five years from 5.3% for the year ended June 30, 2007, to 0.78% for the year ended June 30, 2011.

The State Board of Finance is primarily responsible for the Arkansas State Treasury Investment Policy and the types of investments allowed, as established by Arkansas Code. The State Board of Finance is composed of the Governor, Treasurer of State, Auditor of State, Bank Commissioner, and Director of the DFA. The Governor chairs the Board, and the Treasurer of State serves as the secretary. The Board generally meets twice a year to discuss any changes to the Treasury Investment Policy and to approve the rate required for the Treasury certificates of deposit. The current Treasury Investment Policy was adopted June 25, 1997, and has been amended twice.

The objective of the report was to review the current Arkansas State Treasury Investment Policy and identify possible opportunities for enhancement. DLA staff reviewed the Arkansas State Treasury Investment Policy, Arkansas Code related to Treasury investments, and Treasury cash and investment holdings during the year ended June 30, 2011. Additionally, DLA staff analyzed each of the stated Treasury Investment Policy objectives of safety, liquidity, and return on investment to identify possible opportunities for enhancement. Treasury investment practices were compared to investment practices of the State's largest retirement systems for the year ended June 30, 2011.

The current Treasury Investment Policy approved by the State Board of Finance states that the objectives of the Treasury's investment practices, in priority order, are safety, liquidity, and return on investment. To meet these objectives, the State Treasurer and designated investment officers will:

- Seek to ensure the preservation of capital by adhering to all restrictions on the investment of funds by law and the Treasury Investment Policy.
- Maintain liquidity by seeking to match the maturity structure of the portfolio to reasonably anticipated cash requirements, as well as maintaining an adequate portion of the portfolio in readily marketable securities.
- Optimize the return on investment by structuring the portfolio in such a way that a market rate of return is earned through budgetary and economic cycles within the existing constraints of safety and liquidity.

DLA staff compared the Treasury's investment practices associated with each of these objectives with the investment practices of the Arkansas Public Employees Retirement System (APERS) and the Arkansas Teacher Retirement System (ATRS). Treasury investment practices were only compared to the fixed income portions of APERS and ATRS because they are very similar to Treasury holdings. Other portions of the APERS and ATRS portfolios, such as equity securities and real estate holdings, were not included in the analysis.

Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices (continued)

APERS and ATRS receive higher rates of return on investment than does the Treasury, primarily because the current Treasury Investment Policy prohibits the Treasury portfolio from having an average maturity longer than five years; conversely, the bond portfolios of the retirement systems are allowed to exceed 10 years. Further, the Treasury's investments are primarily government obligations, while the retirement systems' bond portfolios contain a higher proportion of corporate obligations. Nearly all of the Treasury's government obligation bonds are backed by mortgage-based instruments. Investing exclusively in these types of bonds could create a concentration risk in the Treasury investment portfolio.

Fixed income investments at the retirement systems are historically very safe. The Treasury investment practice of only investing in bonds backed by the U.S. government is an even safer approach. In certain economic situations, depending on the individual investment management decisions made, losses are possible and have recently occurred in fixed income portfolios at the retirement systems and the Treasury. To authorize the Treasury to invest in longer-term bonds and certain corporate bonds, selected sections of Arkansas Code and the Treasury Investment Policy will need to be changed.

As seen in Exhibit I on page 3 of the report, at June 30, 2011, the Treasury held $1.3 billion in short-term cash and cash equivalents (representing 40% of Treasury holdings) that could be accessed at any time for immediate expenses. The percentages of cash and cash equivalents for APERS and ATRS were 2.5% and 1.9%, respectively. DLA analysis indicated that Treasury receipts generally supply most of the liquidity needs of the Treasury. When additional liquidity is needed, it is only needed for a short period of time, usually less than one month, and the amount is a very small fraction of the usual balance of cash and cash equivalents on hand. The average Treasury holdings for the two-year period ending June 30, 2011, never decreased more than 7.4% ($252 million) or increased more than 6% ($203 million) in any one month. Maintaining excessive amounts of cash and cash equivalents negatively affects the overall return on Treasury holdings because the rates of return on these accounts are currently less than 0.02%.

Assuming Treasury liquidity needs remain constant and funded by current receipts, the balance of cash and cash equivalents on hand could be significantly decreased. For example, based on DLA analysis, subtracting the largest liquidity need based on month-end balances ($252 million) from the average amount of liquidity maintained ($1.211 billion) reveals that excess liquidity of approximately $1 billion was maintained for the two-year period analyzed. If $1.0 billion were moved from cash and cash equivalents into U.S.-backed bond obligations earning 2.0% that were held by the Treasury at June 30, 2011, *an additional $20.0 million in annual earnings would have resulted.* Total Treasury investment earnings were $24.9 million for the 2011 fiscal year.

As seen in Schedule 1 on page 6 of the report, the five-year average rate of return on fixed income investments at APERS and ATRS was 7.52% and 7.44%, respectively, while the Treasury's rate of return on holdings was 2.74%. Each 1% increase in rate of return on all Treasury holdings at June 30, 2011, would have produced *an additional $32.66 million in earnings per year for the State.*

Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices (continued)

A modified Treasury Investment Policy could improve the overall rate of return. The September 2012 report titled "Arkansas State Treasury – Review of Selected Bond Investment Transactions" provides information related to certain transactions that reduced the rate of return on Treasury investments. The report also demonstrates the need for more oversight and input from the State Board of Finance and greater segregation of duties in the Treasury investment process. Furthermore, an increase in the Treasury rate of return would benefit the Budget Stabilization Trust and General Improvement Funds that, on average, received 87.40% of the earnings from Treasury investments over the last 10 years. A more detailed description of the distribution of investment earnings is provided in Appendix A on page A-1 of the report.

Some significant investment practices at APERS and ATRS could provide better internal controls over Treasury investments. Specifically, both APERS and ATRS:

- Contract with investment consultants who advise their boards on ranges and types of investments in their portfolios and assist the boards in assessing risk, evaluating money managers, and developing an overall investment strategy.
- Contract with money managers to carry out specific investment objectives.
- Use their boards to periodically review performance targets and approve investment strategy and the hiring of consultants and money managers.

The current Treasury Investment Policy allows the use of consultants and outside money managers, but the Treasury does not use these services. Furthermore, the State Board of Finance does not exercise oversight authority over most Treasury investment decisions.

DLA analysis of the internal controls related to the investment of Treasury funds indicated a lack of segregation of duties associated with the investment responsibilities of the Treasury. Use of other investment practices by the Treasury would provide additional information and documentation related to investment decisions.

Small increases in the rate of return on Treasury holdings will produce significant increases in earnings for the State. To achieve these increases, the State Board of Finance, the Treasury, and the General Assembly should determine if a slight increase in risk in the investment portfolio is acceptable. Also, the Treasury should evaluate its liquidity needs to optimize overall return on investment.

Cooperation from many government offices and multiple branches of government will be essential for changing the State's method of investing Treasury funds. Specific changes to Arkansas law will be required, funding issues will need to be resolved, traditional duties may need to be reassigned or shared, and new policies may need to be developed. However, such efforts could result in a significant, continuous source of revenue for the State.

The following recommendations are intended to provide general suggestions for improving investment of Treasury funds.

Special Report – Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices (continued)

- The State Board of Finance and the Treasury should consider contracting with an independent investment consultant for a comprehensive analysis of Treasury investments and recommendations for new investment policies and practices.
- The State Board of Finance and the Treasury should consider placing funds with outside money managers and allowing them to make specific investment decisions within given criteria.
- The State Board of Finance should consider developing a new Treasury Investment Policy, based on recommendations from an independent investment consultant, with the intent of enhancing Treasury investment options and ensuring the Treasury is obtaining the maximum rate of return on its investments without significantly increasing risk.
- The State Board of Finance and the Treasury should develop procedures that facilitate the Board serving a more active role in oversight of Treasury investment activities.
- The General Assembly should consider expanding the composition of the State Board of Finance to include private citizens who are experts in financial investment to allow the Board a greater opportunity to provide experienced financial oversight to the Treasury.

Management response is provided in Appendix B on page B-1 of this report and in Appendix A of the September 2012 report titled "Arkansas State Treasury – Review of Selected Bond Investment Transactions."

Committee Questions/Comments

Representative Meeks asked what the cost to the State was for broker commissions on the bond transactions reviewed. Mr. Moore replied that DLA staff have not seen documentation for all the transactions; however, available documentation shows that St. Bernard earned $2.3 million in commissions related to transactions with the Treasury.

Representative Burris asked for the total investment loss to the State based on the transactions reviewed. Mr. Moore replied that, for the period covered by the Review of Selected Bond Investment Transactions report, the total economic loss was roughly $58,000 and that the loss for a single transaction that occurred in 2010 totaled roughly $835,000. Representative Burris asked if these amounts included opportunities for profit that were lost, to which Mr. Moore replied no. Representative Burris asked if an aggregate total was available, to which Mr. Moore replied no.

Senator Williams asked if the difference in earnings percentage between APERS/ATRS and the Treasury was approximately 5%, to which Mr. Moore replied yes. Senator Williams asked if each point represented about $30 million; Mr. Moore replied that each point represented $32.6 million. Senator Williams asked if the annual loss to the State was approximately $150 million per year, to which Mr. Moore replied yes.

Committee Questions/Comments (continued)

Representative Rice asked for clarification regarding records that were missing from the Treasurer's Office. Mr. Moore identified them as trade records and added that DLA staff later obtained the records from the Arkansas Securities Department, which obtained them from the brokerage firms. In addition, Mr. Moore stated that financial statements from the brokerage firms were missing as well.

Senator Rapert asked if records indicated the early sale of bonds occurred only in the past few years or for many years. Mr. Moore replied that the early sale of bonds began in fiscal year 2010. Senator Rapert asked how many different firms were involved in these transactions, to which Mr. Moore replied three. Senator Rapert how many transactions occurred with each firm; Mr. Moore replied that he did not have that total. Senator Rapert asked how many transactions occurred with firms other than St. Bernard. Mr. Moore replied that of the 11 transactions covered in the report and the one transaction analyzed subsequent to the report, five were with St. Bernard, two were with Morgan Keegan, and the rest were with Bank of Oklahoma. Senator Rapert asked if all of these transactions took place in 2010. Mr. Moore replied that they occurred subsequent to June 30, 2011.

Representative Hammer asked if any of the State's investment activity took place with Apple Tree and St. Bernard prior to 2008. Mr. Moore replied that DLA staff did not look at that time period but that he did not think there were any transactions with those firms prior to 2008.

Representative McCrary asked for further explanation of how step-up bonds operate. Mr. Moore stated that these bonds have an option for a rate increase and are called if the market won't support the increase. Representative McCrary asked if the bonds in question were called, to which Mr. Moore replied no.

Senator Williams asked why Apple Tree and St. Bernard are combined in Exhibit II of the Review of Selected Bond Investment Transactions report. Mr. Moore replied that the Treasury used a single broker who was first with Apple Tree and then with St. Bernard. Senator Williams asked if the Treasury investments followed the broker individually rather than the organization, to which Mr. Moore replied yes.

Senator Dismang asked if the single transaction resulting in a loss of over $800,000 would indicate the need to examine transactions dating back to 2009. Mr. Moore replied that the Committee would make that decision. Senator Dismang stated that he would like to see the Committee consider authorizing such an examination to learn the State's total loss.

Co-Chair Representative Summers asked Mr. Moore to elaborate on the letter of caution issued to St. Bernard by the Arkansas Securities Department. Mr. Moore replied that the letter basically cites the firm's poor record keeping regarding advice given to clients. Co-Chair Representative Summers read the following portion of the letter:

Committee Questions/Comments (continued)

> The [Securities Department] Staff strongly cautions [Robert] Keenan [Jr.] and St. Bernard concerning the following violations: In violation of Ark. Code . . . Keenan and St. Bernard failed to have a reliable electronic email retention system until the late fall of 2010. As a result of this failure, vital information contained in any emails that were not retained is currently unavailable for the Staff to review. This information includes, but is not limited to, details about securities offered and sold by St. Bernard to Arkansas clients, risk and suitability information provided to Arkansas clients by St. Bernard, possible concerns or complaints Arkansas clients may have had concerning securities offered and sold by St. Bernard, and Arkansas client's instructions concerning securities transactions handled by St. Bernard.
>
> The Staff strongly cautions Stephens concerning the following violation:
>
> . . . [Steele V. Stephens] cannot produce any corroborated verbal or written evidence that at the time of the sale he provided the Arkansas State Treasurer's Office with necessary information concerning a replacement bond that was sold to this institutional customer in January 2010. Without this corroborated verbal or written evidence, the Staff cannot determine whether Stephens met his suitability obligations to the Arkansas State Treasurer's Office under said FINRA rule. Specifically, it is impossible for the Staff to determine that Stephens had a reasonable basis for concluding that the Arkansas State Treasurer's Office was making an independent investment decision, when this bond replacement was sold by Stephens.
>
> The Staff has serious concerns that the missing written records, as stated above, may have contained evidence of violations of Ark. Code . . . In addition, the Staff has serious concerns that the missing written records, as stated above, may have contained evidence that Keenan and St. Bernard failed to fulfill the supervisory requirements contained in Ark. Code . . . .

In response to Representative McCrary's previous question, Senator Rapert explained how step-up notes operate. Senator Rapert read the following statement from the Treasurer of State's response to the Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices report, which is located in Appendix B of the report: "One area of consideration for potential yields on the bonds Treasury sold were step up bonds. Based on historical data, none of these bonds ever increased to the higher yield; therefore, selling the bonds at a profit was a logical choice." Senator Rapert asked DLA staff to follow up on this statement because, based on his knowledge as a financial advisor, the statement is inaccurate and misleading.

Representative Mayberry asked for clarification regarding whether a single broker was employed by both Apple Tree and St. Bernard, to which Mr. Moore replied yes. Representative Mayberry asked if this broker is still involved in transactions at the Treasurer's Office, to which Mr. Moore replied yes. Representative Mayberry asked how long this broker has had a relationship with the Treasurer's Office. Mr. Moore replied that, based on DLA's examination, the relationship appears to have begun in 2008 when the broker was with Apple Tree.

Committee Questions/Comments (continued)

Representative Hammer asked if the top three firms involved in Treasury investments are involved in investments at APERS and ATRS. Mr. Moore replied that he did not have that information. Representative Hammer asked if Apple Tree and St. Bernard refer to firms or people representing themselves with the names of these firms. Mr. Moore replied that they are firms and added that Apple Tree is no longer in business. Representative Hammer asked when Apple Tree went out of business; Mr. Moore replied that he wasn't sure.

Senator Chesterfield apologized to the Committee for her absence from the meeting held Friday, September 14, explaining that she experienced a death in her family. Senator Chesterfield asked if any allegations of misconduct were made regarding Treasurer of State Martha Shoffner's investment decisions. Co-Chair Senator Pritchard replied that no testimony was heard on Friday. Senator Chesterfield noted that the reports do not state they will be sent to a prosecuting attorney and asked if any specific allegations led to the subpoenas issued for Ms. Shoffner. Co-Chair Senator Pritchard replied that the purpose of the Friday meeting was to hear Ms. Shoffner's response to the reports, and she chose not to attend. Senator Chesterfield asked if members of Ms. Shoffner's staff were present at the Friday meeting, to which Co-Chair Senator Pritchard replied yes. Senator Chesterfield if they were unable to answer Committee questions. Co-Chair Senator Pritchard replied that the Committee did not hear the reports or entertain questions without Ms. Shoffner present because her testimony was important and she should have the opportunity to address the issues contained in the reports. Senator Chesterfield asked if anyone from the Treasurer's Office had expressed any aversion to considering the recommendations contained in the reports. Co-Chair Senator Pritchard replied that that issue would be explored when the Committee directs questions to representatives from the Treasurer's Office. Senator Chesterfield stated that she was trying to understand if prosecutable conduct prompted Legislative Auditor Roger Norman to issue the subpoenas for Ms. Shoffner. Co-Chair Senator Pritchard clarified that the purpose of the subpoenas was only to compel Ms. Shoffner to attend the Committee meeting.

Regarding the recommendations on page 5 of the Review of State Board of Finance Treasury Investment Policy and Treasury Investment Practices report, Representative Hammer asked if the recommended policies and practices are similar to those used at APERS and ATRS, to which Mr. Moore replied yes. Representative Hammer asked if the Treasury should see returns similar to those experienced by APERS and ATRS if it follows the recommendations contained in the report. Mr. Moore replied that he could not predict that. Mr. Norman added that the Treasury has different investment objectives than APERS and ATRS, so strict comparisons cannot be made; however, the Treasury's entire investment process warrants examination.

Representative Hammer asked if Ms. Shoffner was aware of the seriousness of the reports before the September 14 Committee meeting and how she was made aware of the meeting. Mr. Moore stated that the findings and recommendations were explained to Ms. Shoffner at the exit conference. Representative Hammer asked how far in advance Ms. Shoffner knew the date of the Committee meeting. Mr. Moore replied that she was informed of the meeting at the exit conference, which was held August 16, and that she indicated she could attend.

Committee Questions/Comments (continued)

Senator Chesterfield asked for confirmation that ATRS has lost vast amounts of money over the past 10 years. Mr. Norman replied that ATRS' losses have been primarily in equity investments, not the fixed income investments DLA examined at the Treasury. Senator Chesterfield asked for confirmation that ATRS, APERS, and Treasury have all lost money. Mr. Moore replied that they have not all lost money in fixed income investments. Senator Chesterfield asked if, overall, the three systems have lost money, to which Mr. Moore replied yes. Senator Chesterfield asked if APERS and ATRS had serious losses; Mr. Moore replied that both systems experienced losses after 2008.

Senator Dismang reiterated that DLA compared the low-risk fixed income investments of APERS and ATRS to Treasury investments, adding that APERS' and ATRS' investments often involve higher risk because the systems' goal is to produce the highest return possible. Mr. Moore confirmed Senator Dismang's statement. Senator Dismang stated that the bottom line is that higher returns would have resulted for the State if the Treasury had placed some of its liquid assets (40% of total Treasury holdings) in these types of fixed rate, secure investments, rather than keeping them in accounts that earn next to nothing.

Co-Chair Senator Pritchard administered an oath to each of the following witnesses: Ms. Shoffner; Debbie Rogers, Chief Deputy Treasurer for the Office of the Treasurer; Autumn Sanson, Chief Investment Officer for the Office of the Treasurer; and Melissa Corrigan, Chief Financial Officer for the Office of the Treasurer.

Ms. Shoffner apologized to Committee members for missing the Friday meeting and stated that she is working to make the best investments possible for the people of Arkansas and wants to work with DLA regarding the findings communicated in the reports. She also cited the nationwide economic downturn, the five-year limit on Treasury investments, and the need for changes in the Treasury Investment Policy as factors in low yields. Regarding the percentage of liquid assets, Ms. Shoffner reminded the Committee that the Treasurer's Office pays all of the State's bills but also admitted that some of those funds could be invested to gain earnings for the State.

Co-Chair Senator Pritchard asked Ms. Shoffner when she was notified of Friday's meeting and why she was not present. Ms. Shoffner stated that she was told of the meeting date at the exit conference with DLA staff but had to be away due to a last minute economic development opportunity in her home county in eastern Arkansas and was relying on her staff to respond on her behalf. She stated that she was not traveling in a state car but received a phone call from an Arkansas State Police (ASP) Trooper at 11 a.m. and waited four hours at a police station to be served the subpoena, which she was finally served at her home late Friday afternoon.

Co-Chair Senator Pritchard stated that he spoke with Ms. Shoffner on the phone at 8:50 a.m. on Friday; that Ms. Shoffner said she would not be attending the Committee meeting; that he informed Ms. Shoffner her attendance was required; and that he told her the meeting could be postponed until later on Friday to allow her to attend; however, Ms. Shoffner indicated that she would not be available later in the day. Ms. Shoffner confirmed these statements as accurate and asked if her staff members were told to contact her and tell her to return for the meeting.

Committee Questions/Comments (continued)

Co-Chair Senator Pritchard stated that he notified Ms. Shoffner that the Committee has subpoena powers and would subpoena her if she did not attend Friday's meeting. Ms. Shoffner stated that she did not receive the first two subpoenas, only the third. Co-Chair Senator Pritchard clarified that the first subpoena was for the Friday meeting being held at 11 a.m. When the ASP could not serve the subpoena timely, the decision was made to schedule a new meeting for 2:00 p.m. Monday (today) and to have the Legislative Auditor issue a second subpoena for that meeting, which was served on Ms. Shoffner Friday afternoon.

Representative Burris asked Ms. Shoffner if someone from her staff notified her about the first subpoena. She replied yes but that she was told to wait where she was for it to be served. Representative Burris asked Ms. Shoffner at what point her plans to attend Friday's meeting changed since it was clear that she was expected to attend and that her intention at the exit conference seemed to be to attend. Ms. Shoffner replied that she was notified of the economic development opportunity the previous Wednesday (September 12) and stated her understanding that state agency heads usually do not attend Committee meetings. Representative Burris read a memorandum from DLA to Ms. Shoffner dated August 22, notifying her of the meeting date and time, strongly encouraging her to attend, and confirming that she was planning to attend.

Co-Chair Senator Pritchard asked Ms. Rogers if she spoke to Ms. Shoffner Friday about the meeting and subpoenas. Ms. Rogers stated that she contacted Ms. Shoffner after 11 a.m., told her to wait for the subpoena, and told her that the Committee had recessed until 1 p.m. Co-Chair Senator Pritchard asked Ms. Sanson and Ms. Corrigan if they spoke to Ms. Shoffner Friday; both replied no.

Co-Chair Representative Summers asked Ms. Shoffner if any relationship existed between Apple Tree or St. Bernard and the Treasury before she took office, to which she replied no. Co-Chair Representative Summers asked Ms. Shoffner to explain her relationship with those firms. She stated that the father of the broker is from her home county but that she had no relationship with them before her term as State Treasurer. Co-Chair Representative Summers asked Ms. Shoffner to explain the guidelines for selecting a new broker. Ms. Shoffner replied that potential new brokers interview with her or her staff and submit a proposal, which she and her staff review. Co-Chair Representative Summers asked Ms. Shoffner if any broker can approach her office with a proposal, to which she replied yes. Co-Chair Representative Summers asked how many new brokers the Treasury has established a relationship with since it became affiliated with Apple Tree and St. Bernard, to which Ms. Sanson replied none. Ms. Shoffner asked Ms. Sanson for the total number of brokers with whom the Treasury has relationships; Ms. Sanson replied 14-20. Co-Chair Representative Summers asked Ms. Shoffner if she was aware of any violations of investment policy or securities laws by any of the brokers used by the Treasury; Ms. Shoffner replied no. Co-Chair Representative Summers asked Ms. Shoffner if she was aware of any wrongdoing by herself or her staff, to which she replied no.

Co-Chair Representative Summers asked Ms. Shoffner who is responsible for making and approving investment transactions. Ms. Shoffner named Ms. Rogers, Ms. Sanson, herself, and Karla Shepherd, who served as Chief Deputy Treasurer prior to Ms. Rogers. Co-Chair Representative Summers asked Ms. Shoffner what yield analysis model she, Ms. Rogers, and Ms. Sanson use when making investment decisions. Ms. Sanson replied that they obtain proposals from brokers and weigh the yields for the time periods of the investments.

Committee Questions/Comments (continued)

Co-Chair Representative Summers asked Ms. Shoffner if the three firms with which the Treasury did the most business offered better proposals than others. Ms. Shoffner replied that it depends on the type of bond being invested in. Ms. Shoffner added that the Treasury is no longer selling bonds or buying premiums. Co-Chair Representative Summers asked Ms. Shoffner if the differences between brokers were in terms of yield and expense to the Treasury since brokers had access to the same types of bonds; Ms. Shoffner replied yes. Co-Chair Representative Summers asked Ms. Shoffner if the three firms with which the Treasury did the most business offered lower costs to the State than other brokers; Ms. Shoffner replied that she did not know.

Co-Chair Representative Summers asked who decides how much is retained as liquid assets. Ms. Corrigan replied that the amount held is evaluated daily and that some expenses are expected, such as payroll for state employees and tax refunds in March and April. Co-Chair Representative Summers asked Ms. Corrigan how much of the $1.25 billion held in liquid assets is truly needed and if she agrees with the report's statement that $250 million should be sufficient. Ms. Corrigan replied that it depends on the time and month of the year. Co-Chair Representative Summers asked Ms. Shoffner if she was aware of the letter of caution issued to St. Bernard by the Arkansas Securities Department; she replied that she just learned of it today. Co-Chair Representative Summers noted that the letter is dated August 29. Ms. Shoffner added that total interest deposited in the State over a four-year period was $162 million and that the Treasury tries to be safe in its investments but would consider DLA's recommendations for new procedures.

Co-Chair Senator Pritchard asked who makes the final investment decision if Ms. Rogers, Ms. Sanson, and Ms. Shoffner disagree. Ms. Rogers stated that Ms. Sanson speaks with brokers and compiles their offers and that the three of them compare the offers, discuss them at length, and consider the yield and call before making a mutual decision every time. Ms. Sanson stated that the three of them do discuss every investment; however, the State Treasurer makes the final decision. Co-Chair Senator Pritchard asked why bonds were sold before maturity or call since the Treasury held $1.3 billion in liquid assets. Ms. Rogers stated that the bonds were not sold to meet liquidity needs. Co-Chair Senator Pritchard asked who made the decision to sell the bonds. Ms. Rogers stated that, after she became Chief Deputy, she, Ms. Shoffner, and Ms. Sanson decided to sell the bonds. Ms. Shoffner added that the Treasury would not be selling bonds again. Ms. Sanson confirmed that the bonds were not sold because of liquidity needs and stated that the State Treasurer makes the final decision regarding bond sales.

Co-Chair Representative Summers asked if the three make the investment decisions or if Ms. Shoffner makes those decisions. Ms. Shoffner stated that the three of them collaborate but that she signs off on the final decision.

Co-Chair Senator Pritchard reminded Committee members that a time limit would be applied if the list of members wishing to ask questions continued to grow.

Representative Mayberry asked Ms. Shoffner to confirm that her staff did not notify her of the subpoena issued to compel her to attend the 11 a.m. Friday meeting, even though staff members were present when the subpoena was announced at 9 a.m. Ms. Rogers stated that she did not see the subpoena and did not know proper procedures regarding it.

Committee Questions/Comments (continued)

Representative Mayberry asked Ms. Rogers if she was in the room when the subpoena was announced, to which Ms. Rogers replied yes. She added that she did not call Ms. Shoffner because she did not want to break protocol. Representative Mayberry asked Ms. Shoffner why she didn't offer to meet the Trooper seeking to serve the subpoena in Little Rock after the Trooper called her. Ms. Shoffner stated that she was shocked that she was subpoenaed and didn't think about offering to meet the Trooper in Little Rock. Representative Mayberry asked Ms. Shoffner if any new brokers have approached the Treasury with proposals, to which she replied no.

Citing the Treasury's statement in the response to the reports that it "felt it obligatory to try a different approach to generate more money," Representative Mayberry asked Ms. Shoffner on what this new approach was based if not on the advice of outside consultants. She replied that decisions are made internally and that she will consult outside consultants in the future. Representative Mayberry asked each person representing the Treasury to explain her investment background prior to her current position. Ms. Sanson stated that she has worked for the Treasury for 12 years in such divisions as cash management and investments, has been in her current position six years, and has a degree in finance. Ms. Rogers stated that she has worked for the Treasury since 1984 in such areas as investments, receipts, and local government services. Ms. Shoffner stated that she was a state legislator and served on the Joint Budget Committee. Representative Mayberry asked if any of the Treasury staff present are Series 7 licensed, to which Ms. Shoffner replied no. Representative Mayberry asked if they made investment decisions regarding extremely large sums without outside consultation, even though none of them are Series 7 licensed, to which Ms. Shoffner replied yes. Representative Mayberry asked the Treasury staff if they agree that their investment decisions have cost the State tremendously. Ms. Sanson replied that they rely on brokers to advise them on investments because of the large amounts of money involved. Representative Mayberry asked if the broker who has received the most business from the State provided the chief consultation regarding investment decisions that went through that broker; Ms. Sanson and Ms. Rogers replied yes.

Senator Chesterfield asked Ms. Corrigan to share her investment background. Ms. Corrigan replied that she has been with the Treasury for 23 years and has worked in such areas as cash management, payroll, personnel, and purchasing before becoming CFO. Noting that only Ms. Sanson has any investment background, Senator Chesterfield stated that the primary question is this: Why would the Treasury would sell the bonds for a loss? Ms. Sanson asked if she would be protected under the Whistleblower Act. Co-Chair Senator Pritchard stated that he could not make that determination and that Ms. Sanson would have to consult with an attorney. Senator Chesterfield asked if Ms. Sanson had the right to not answer a question if it would incriminate her and, if not, stated that she would like to ask Ms. Rogers, Ms. Shoffner, and Ms. Sanson to explain why they sold the bonds for a loss. Senator Chesterfield directly asked Ms. Shoffner twice why the bonds were sold for a loss. Ms. Shoffner asked Senator Chesterfield which bond she was referring to; Senator Chesterfield replied that she was referring to the sales that resulted in the $58,000 loss to the State. Ms. Rogers began to reply, and Senator Chesterfield interrupted her, stating that her question was for Ms. Shoffner. When Ms. Shoffner requested that Ms. Rogers be allowed to answer the question, Senator Chesterfield asked if Ms. Rogers made the investment decision.

Committee Questions/Comments (continued)

Co-Chair Senator Pritchard suggested that Mr. Moore address Senator Chesterfield's question. Mr. Moore stated that DLA staff analyzed 12 transactions in which bonds were sold prior to maturity or call date and determined that the State experienced a $58,000 loss as a result of those 12 transactions. Senator Chesterfield asked again why the Treasury sold the bonds. Ms. Sanson stated that she could not answer that question. Senator Chesterfield again directed her question to Ms. Shoffner. Ms. Shoffner stated that some of the sales yielded a net gain. Senator Chesterfield asked if anyone employed at the Treasurer's Office is a certified public accountant; her question received no verbal response. Senator Chesterfield asked DLA staff to explain why these losses are different from those experienced at APERS and ATRS and asked again why the Treasury would sell bonds early. Mr. Moore replied that only the Treasurer can answer the second question. He added that Exhibit I on page 3 of the Review of Selected Bond Investment Transactions report compares the interest the sold bonds earned to the interest they would have earned had they not been sold in order to arrive at the net gain/loss figures. Senator Chesterfield again asked why the bonds were sold early, and Ms. Shoffner replied that she did not know and would have to research it. Senator Chesterfield asked if anyone knew the answer to her question. Ms. Rogers replied that the Treasury could sell the bonds at a premium and receive additional funds. Senator Chesterfield asked if that happened, and Ms. Rogers replied yes, citing that DLA factored into its calculation the time that the funds were in a money market account earning a reduced interest rate.

Co-Chair Senator Pritchard asked if the broker recommended the sale of the bonds before maturity or call date in the case of the 12 transactions being discussed; Ms. Sanson replied yes. Co-Chair Senator Pritchard added that if Ms. Sanson decided to plead the Fifth Amendment, DLA legal counsel could explain her rights. Co-Chair Senator Pritchard asked why the Treasury took the broker's advice. After no one responded to the question, Co-Chair Senator Pritchard asked Ms. Shoffner if she made the decision to sell the bonds based on the broker's advice. Ms. Shoffner replied that she didn’t make the decisions and did not remember why the bonds were sold. Co-Chair Senator Pritchard asked Ms. Rogers if she made the decision to sell the bonds. Ms. Rogers stated that she, Ms. Shoffner, and Ms. Sanson made the decision to sell the bonds each time. Co-Chair Senator Pritchard asked Ms. Sanson if she made the decision to sell the bonds. Ms. Sanson asked again if she would be protected under the Whistleblower Act. Senator Rapert stated that Ms. Sanson would be protected whether the Committee said so or not. Co-Chair Senator Pritchard stated that the Committee could not determine whether she would be protected. Co-Chair Senator Pritchard asked where the money from the bond sales went and when bonds were repurchased. Ms. Rogers stated that the funds were placed in a money market account until replacement bonds were chosen, as shown in Exhibit I of the Review of Selected Bond Investment Transactions report, which could have been as soon as the same day. Co-Chair Senator Pritchard stated that reinvesting the money the same day would have been preferable to allowing it to sit in a low-interest account, and Ms. Rogers agreed. Co-Chair Senator Pritchard asked if the repurchased bonds paid a higher yield, and Ms. Rogers stated that she did not know. Co-Chair Senator Pritchard asked if the broker received a commission on the sale and the repurchase of the bonds. Ms. Rogers replied that she did not have any information on commissions.

Committee Questions/Comments (continued)

Senator Sample asked Ms. Sanson to explain the criteria that she, Ms. Rogers, and Ms. Shoffner used when selecting a broker. Ms. Sanson replied that they examined the broker's reputation among other state agencies and the yields offered these agencies, noting that the Treasury has not added many brokers in recent years. Senator Sample asked if the decision to select a broker is based solely on the product being offered, to which Ms. Sanson replied no. Senator Sample asked Ms. Sanson to explain the rationale for selling the bonds before maturity or call date. Ms. Sanson replied that the broker said the Treasury would make a profit if it sold the bonds early.

Senator Rapert asked Ms. Shoffner who signs authorizations related to investment decisions. Ms. Shoffner stated that she and Ms. Sanson do. Senator Rapert asked Ms. Shoffner if anyone on her staff told her not to sell the bonds early; Ms. Shoffner replied no. Senator Rapert asked Ms. Rogers if anyone on the staff advised Ms. Shoffner that it was not customary to sell bonds early; Ms. Rogers replied not to her knowledge. Senator Rapert asked Ms. Sanson if anyone on the staff advised the Treasurer that it was not customary to sell bonds prior to maturity or call dates; Ms. Sanson replied that she did. Senator Rapert asked Ms. Corrigan if anyone on the staff advised the Treasurer not to make the bond sales early; Ms. Corrigan replied that she is not part of the meetings regarding investment decisions. Senator Rapert asked Ms. Corrigan if she ever heard that someone on the staff had advised the Treasurer not to make the bond sales early; Ms. Corrigan replied no, adding that investment decisions have already been made when they reach her. Senator Rapert asked Ms. Rogers if former Chief Deputy Shepherd advised the Treasurer that it was not customary to sell bonds prior to maturity or call dates; Ms. Rogers replied that she did not know. Senator Rapert asked Ms. Shoffner to explain why the decision was made to sell the bonds prior to call or maturity date; Ms. Shoffner replied that she did not know but would research it. Senator Rapert asked why, on certain days, $100 million was invested with St. Bernard and only $25 million invested with other firms if all the firms were offering the same bonds with the same yields. Ms. Shoffner replied that she did not know but would research it. Senator Rapert asked if Ms. Shoffner showed preference to one firm over another regarding the transactions in question. Ms. Shoffner stated that she did not know but would research it.

Representative Hammer asked about the procedures for pleading the Fifth Amendment or seeking Whistleblower Act protection under oath before the Committee; Frank Arey, DLA Legal Counsel, explained both. Representative Hammer asked if the Committee has the authority to grant Ms. Sanson Whistleblower Act protection. Mr. Arey replied that both the Committee and DLA are named in the Act; however, if the Committee granted Ms. Sanson Whistleblower protection, a court might not honor the Committee's decision. Representative Hammer asked Mr. Arey if he knew of any situations similar to the current one and how a court ruled; Mr. Arey replied that he was not aware of any similar situations. Representative Hammer asked Ms. Sanson if information regarding the five-year history of declining yield of Treasury investments, as shown in Schedule 1 on page 6 of the Review of State Board of Finance Investment Policy and Arkansas State Treasury Investment Practices report, was discussed among herself, Ms. Rogers, and Ms. Shoffner. Ms. Sanson replied that they understood the yield was declining primarily due to the economic climate. Representative Hammer asked why the broker affiliated with Apple Tree and St. Bernard was used after a history of decline and if the Treasury still uses this broker. Ms. Sanson stated that the Treasury still uses the broker in question but that the decline could not necessarily be blamed on the broker since all brokers were experiencing a decline.

Committee Questions/Comments (continued)

Co-Chair Representative Summers asked Ms. Sanson why she felt she needed Whistleblower Act protection. Ms. Sanson replied that the advice she gave to Ms. Shoffner was not heeded, resulting in the Treasury going in the wrong direction. Co-Chair Representative Summers asked Ms. Sanson if she feared for her position by answering the Committee's questions, to which she replied yes.

Senator Dismang offered a summary of the multiple issues discussed: First, the CFO did not take into account the seasonal fluctuations of cash needs, resulting in a significant amount of state funds sitting in low-earning money market accounts. Second, Senator Dismang stated that Ms. Shoffner has final authority on all transactions, has had the DLA reports, and went through the exit interview; therefore, Ms. Shoffner's inability to answer the Committee's questions indicates poor leadership and/or a lack of diligence. Third, Senator Dismang stated that the Treasurer's Office is ineffectively using taxpayer dollars, especially in light of $20 million budget discussions in the last fiscal session, which is less than what the Treasury lost because it did not oversee investments properly.

Senator Dismang cited a news report dated October 29, 2011, in which it was identified that the Treasury had $480 million invested with one broker (St. Bernard) and to which Ms. Shoffner replied that she did not realize the situation had gotten "out of hand." Senator Dismang asked Ms. Shoffner to explain what she has done since that time to remedy the situation; Ms. Shoffner replied that she did not recall making that statement. Senator Dismang asked Ms. Shoffner what she has done since that time to ensure an excessive amount of money isn't invested with one entity (i.e., St. Bernard). Ms. Shoffner asked if the question was in reference to a $300 million investment, which Senator Dismang confirmed. Ms. Shoffner stated that she consulted with auditors and was told that what matters most is what the money is invested in, not with whom it is invested or how much is invested, so she didn't see the large investment with St. Bernard as a problem. Senator Dismang asked Ms. Shoffner if her comment to members of the press was made to appease them, especially since investments with St. Bernard have doubled since that time, and asked why the investments with St. Bernard doubled. Ms. Shoffner cited her relationships with broker. Citing the importance of diversifying investments, Senator Dismang asked Ms. Shoffner if these relationships were personal, to which she replied no. Senator Dismang asked Ms. Shoffner what the incentive was to have so much invested with St. Bernard. Ms. Shoffner said that St. Bernard offered a good yield. Reminding her that she was under oath, Senator Dismang asked Ms. Shoffner if she was ever advised that those specific transactions were a bad decision, to which Ms. Shoffner replied no.

Co-Chair Senator Pritchard asked Ms. Sanson if she advised Ms. Shoffner not to sell the bonds before call and not to invest so much with a single broker, to which Ms. Sanson replied yes.

Senator Williams asked Ms. Shoffner if she ever received email correspondence containing advice on selling bonds early, to which Ms. Shoffner replied no. Senator Williams asked Ms. Sanson if she ever sent Ms. Shoffner advice via email or was aware of any emails regarding selling bonds early. Ms. Sanson replied that communication usually took place on the telephone or face to face. Senator Williams asked Ms. Sanson if any correspondence exists in which she questioned the broker about selling the bonds early. Ms. Sanson replied that she did question the broker but that the conversations typically took place on the telephone.

Committee Questions/Comments (continued)

Senator Williams asked if there was anything on paper to document Ms. Sanson's conversations with Ms. Shoffner or the broker regarding her reservations about selling the bonds early. Ms. Sanson replied that she did keep a personal log of those conversations. Senator Williams asked Ms. Shoffner if she took seriously Ms. Sanson's advice not to sell the 12 items early. Ms. Shoffner replied that Ms. Sanson did not advise her not to sell the bonds early. Senator Williams asked if the CFO was part of the decision-making process regarding investments, to which Ms. Corrigan replied no. Ms. Shoffner added that she, Ms. Sanson, and Ms. Rogers made a collective discussion and never disagreed and that she consulted DLA auditor Joey Buddenberg about the $300 million investment with a single broker. Senator Williams asked Ms. Shoffner if Mr. Buddenberg advised her to "buy up." Ms. Shoffner reiterated that Mr. Buddenberg said that what matters most is what the money is invested in, not with whom it is invested or how much is invested. Senator Williams asked if a representative from St. Bernard was present, to which Co-Chair Senator Pritchard replied yes.

Because of conflicting statements made, Co-Chair Senator Pritchard asked Ms. Rogers, Ms. Shoffner, Ms. Sanson, and Ms. Corrigan if they all understood completely that their statements were being recorded and they were under oath; all replied yes. Co-Chair Senator Pritchard asked Ms. Corrigan if she was part of any investment discussions as CFO. Ms. Corrigan replied that she was not but simply made the general and special month-end distributions. Ms. Sanson added that the fact that the person who makes the trade is not the same person who moves the money is part of the checks and balances at the Treasury.

Regarding her request for Whistleblower protection, Representative Meeks asked Ms. Sanson if she believed any ethical or legal violations had occurred at the Treasury or regarding the transactions in question. Ms. Sanson replied that she did not know the law well enough to know if anything illegal or unethical occurred but that she advised that the early bond sales were unacceptable. Regarding the fact that Treasury Investment Policy requires the Treasurer to maintain semiannual and annual reports, including audited financial statements, for each securities firm approved by the Treasurer, Representative Meeks asked Ms. Shoffner why the Treasury did not maintain those documents. Ms. Shoffner stated that she had the same question and that she was not sure whose duty it was to maintain those documents, unless it was the duty of the Chief Investment Officer. Ms. Rogers added that retaining the documents is now the duty of the Chief Investment Officer, that Ms. Sanson has obtained all the required documents from current brokers, and that the Treasury would request updated reports in January.

Based on Exhibit I of the Review of State Board of Finance Investment Policy and Arkansas State Treasury Investment Practices report, Senator Key asked if a conscious decision was made from fiscal years 2009 to 2010 to shift substantial funds to U.S.-backed bond obligations and if the same types of obligations were involved in the 11 transactions DLA analyzed. Ms. Shoffner stated that she did not know but would research it. Senator Key asked if the Treasury receives settlement statements from the brokerage firms, to which Ms. Sanson replied yes, adding that the statements do not give the broker's commission or other fees. Senator Key asked if the commission on a called bond is different than the commission on a bond that is sold early. Ms. Sanson stated that a broker makes a commission when a bond is sold but that she was not sure if a broker makes a commission on a bond that reaches its call or maturity date. Senator Key asked who has fiduciary responsibility for seeking the best investment transactions for the State. Mr. Moore stated that fiduciary responsibility rests with the Treasurer of State.

Committee Questions/Comments (continued)

Representative Burris asked Ms. Rogers, Ms. Shoffner, Ms. Sanson, and Ms. Corrigan if anyone at the Treasury received personal benefit from anyone associated with the sale or purchase of the bonds in question; all four replied that they were not aware of any. Representative Burris asked Ms. Sanson if she has retained an attorney, to which she replied no. Representative Burris strongly advised her to do so, given her testimony and her request for Whistleblower protection. Representative Burris asked Ms. Shoffner if she would commit to making no personnel changes regarding Ms. Rogers, Ms. Sanson, or Ms. Corrigan until DLA staff have completed a full investigation based on Committee recommendations and produced a report regarding its findings; Ms. Shoffner replied yes.

Senator Sample asked Ms. Shoffner if Ms. Sanson advised her not to sell the bonds before the call date. Ms. Shoffner replied no and stated that Ms. Sanson was the first to sell the bonds.

Representative Lovell asked for clarification of Exhibit I of the Review of Selected Bond Investment Transactions report. Mr. Moore stated that DLA looked at what the bonds were earning and what happened to the proceeds when they were placed in a money market account, giving credit for the interest earned while in the account. Mr. Moore explained that DLA staff calculated the interest earned when the funds were removed from the money market account and invested in a replacement bond. Representative Lovell asked if premiums gained for early bond sales were included in DLA's calculations, to which Mr. Moore replied yes.

To clarify previous questions by Senator Key, Senator Rapert explained that when a bond is called, it is returned to the investor, and the broker does not earn a commission. Therefore, every time the Treasurer sold a bond before the call or maturity date, the broker made a commission. Regarding Exhibit II of the Review of Selected Bond Investment Transactions report, Senator Rapert asked Ms. Shoffner why she showed favoritism by choosing to do $1.69 billion in business with Apple Tree and St. Bernard and only $886 million in business with the next highest firm. Ms. Shoffner replied that she did not show favoritism. Senator Rapert repeated his question, noting the $804 million difference between the Apple Tree/St. Bernard purchases and the next highest. Ms. Shoffner replied that she could not explain why but would research it. Senator Rapert asked Ms. Shoffner if Ms. Shepherd ever advised her not to sell bonds early, to which Ms. Shoffner replied no. Senator Rapert asked Ms. Shoffner if she ever received donations, remunerations, or financial benefit from St. Bernard or its employees. Ms. Shoffner first replied no and then, when Senator Rapert asked his question a second time, stated that she did receive campaign contributions from St. Bernard.

Representative Mayberry asked Ms. Shoffner why Ms. Sanson would say she advised Ms. Shoffner not to sell the bonds early if she didn't offer such advice. Ms. Shoffner stated that she was surprised by Ms. Sanson's comment and that the only advice Ms. Sanson offered her concerned the $300 million investment. Representative Mayberry asked Ms. Shoffner if Ms. Sanson receives a periodic personnel review, to which Ms. Shoffner replied no. Representative Mayberry asked Ms. Shoffner how she would characterize Ms. Sanson's job performance. Ms. Shoffner stated that Ms. Sanson's job performance is good yet lacking and added that her own is lacking as well, adding that she was "disappointed" in Ms. Sanson.

Committee Questions/Comments (continued)

Representative Mayberry asked Ms. Shoffner to clarify her statement that she knows the family of the broker with whom the Treasury has done the majority of its business, specifically how close the relationship is and how far back it goes. Ms. Shoffner replied that the broker's father is well-known in her home county, that she didn't know the broker before their business relationship, and that her acquaintance with the family goes back to the 1950s and 1960s. She added that the broker approached the Treasury and offered what she thought were the best yields. Representative Mayberry asked Ms. Shoffner if she, her friends, her acquaintances, or her family members have ever received anything of perceived value from anyone associated with the broker. Ms. Shoffner replied that she has only received small gifts, such as golf balls and candy at Christmas.

Senator Dismang asked if any written records are maintained regarding the meetings among Ms. Shoffner, Ms. Rogers, and Ms. Sanson, to which Ms. Shoffner replied no. Senator Dismang asked if St. Bernard provided a written proposal to the Treasury showing that it offered the best yields. Ms. Shoffner replied that the proposal came to the investment department, not to her specifically. Senator Dismang asked if he could get a copy of the proposal demonstrating St. Bernard's yields were higher, to which Ms. Shoffner replied yes.

Senator Dismang asked if DLA's investigation could be expanded to include examination of transactions for the prior four years to see if similar types of sales were made. Mr. Moore stated that DLA currently knows of 29 transactions, 11 of which have already been examined. Senator Dismang made a motion that the scope of the audit be expanded to include similar transactions in the prior four years, which was seconded. Representative Meeks asked that the Treasurer of State and her staff return to the Committee to present the information Ms. Shoffner said she would research and to respond to the subsequent DLA investigation. The motion carried.

Representative Hammer asked if any minutes are kept when Ms. Shoffner, Ms. Rogers, and Ms. Sanson meet to discuss investment decisions. Ms. Corrigan stated that she is not present at the meetings. Ms. Sanson stated that she sometimes keeps records of discussions. Ms. Shoffner replied that she does not keep any notes. Ms. Rogers replied that she keeps some notes. Representative Hammer asked Ms. Shoffner if the State Board of Finance meets twice per year, to which she replied yes. Representative Hammer asked if minutes of those meetings are kept or meetings are recorded, to which Ms. Shoffner replied yes. Representative Hammer asked if the decline in Treasury investments was ever discussed at State Board of Finance meetings; Ms. Shoffner replied that the decline was not discussed, to her knowledge, but that she would research it. Referring to the response to the audit reports by the Treasurer's Office, Representative Hammer asked Ms. Shoffner to define what she meant by the statement that DLA's recommendation to hire outside money managers "will be considered." Ms. Shoffner stated that she desires more consultants to advise the Treasury but is concerned about cost to the State, though hiring consultants appears to be affordable. Representative Hammer asked DLA staff to compare the cost of hiring consultants to the Treasury's investment losses and present that information when the Committee reconvenes.

Committee Questions/Comments (continued)

Representative Hammer asked Ms. Shoffner to explain the measurable criteria used to quit using a broker when the broker's performance does not measure up to what was promised. Ms. Shoffner replied that there are no set criteria, stating her desire to help Arkansas banks and brokers and to spread business around among them. She added that yields have been fairly consistent among brokers. Representative Hammer noted that the Treasury has not spread around its business. Representative Hammer asked Ms. Sanson why she has not resigned from her position if actions at the Treasury have made her uncomfortable and she was not being listened to. Ms. Sanson replied that she has not resigned because she has not done anything wrong.

Senator Key asked how often the Treasury considers proposals from brokers. Ms. Shoffner replied that the Treasury only receives occasional proposals. Ms. Sanson added that four to five proposals are typically compared when she, Ms. Shoffner, and Ms. Rogers make decisions. Senator Key asked if the Treasury solicits proposals. Ms. Sanson replied that it does sometimes solicit them; however, brokers typically communicate with the Treasurer's Office daily regarding market conditions. Senator Key noted that the amount the State invests would make a difference in the type of offers brokers make, which Ms. Sanson confirmed. Senator Key asked how consistently a broker rises to the top above other brokers. Ms. Shoffner stated that the Treasurer's Office tries to get brokers to be competitive in order to raise the rates they are offering.

Co-Chair Senator Pritchard thanked DLA staff for their work, Committee members who stayed for such a lengthy meeting, and members of Treasury staff who answered questions.

Representative Burris asked if the St. Bernard representative would be asked any questions. Citing the length of the meeting, Co-Chair Senator Pritchard stated that questioning him would not add anything to the meeting, especially since the subsequent audit would yield additional information. Co-Chair Senator Pritchard added that DLA staff would do the work needed to fulfill Senator Dismang's motion and would obtain the information from Ms. Shoffner that she said she would research. Co-Chair Senator Pritchard stated that the work would not likely be completed by the scheduled October meeting and that the Committee will not meet in November; however, the Co-Chairs could call a meeting in late October. Senator Key asked if information gathered by DLA could be provided to Committee members before any meeting, to which Co-Chair Senator Pritchard replied yes.

Richard Weiss, DFA Director and member of the State Board of Finance, stated his appreciation for DLA's review of the State Board of Finance Investment Policy.

Heath Abshure, Commissioner of the Arkansas Securities Department, invited those present to contact him with questions about the letter of caution the Commission issued to St. Bernard or any trades made by the Treasury.

Representative Bell asked if the information gathered by DLA could be provided to all legislators who attended today's meeting, in addition to Committee members, to which Co-Chair Senator Pritchard replied yes.

NEW BUSINESS
Mr. Norman presented a request from Representative Bryan King for an audit of Connect Arkansas that was inadvertently omitted from the agenda of the September 13 Executive Committee meeting. There was no objection to this request.

There being no further business, the meeting was adjourned.

FUTURE MEETINGS OF THE LEGISLATIVE JOINT AUDITING COMMITTEE
The next meetings will be held on Thursday and Friday, October 11 and 12, 2012, unless called by the Co-Chairs.

[A complete recording of the proceedings of this meeting may be obtained on CD upon request to our office.]

Legislative Auditor	Chair