



A SPECIAL PERFORMANCE AUDIT

TOBACCO SETTLEMENT INVESTMENT BOARD

FEBRUARY 2009

JACK WAGNER, AUDITOR GENERAL

**PENNSYLVANIA DEPARTMENT OF THE AUDITOR GENERAL
BUREAU OF SPECIAL PERFORMANCE AUDITS**

February 24, 2009

The Honorable John P. Blake
Chairman
Tobacco Settlement Investment Board
Commonwealth Keystone Building
400 North Street, 4th Floor
Harrisburg, Pennsylvania 17120-0225

Dear Chairman Blake:

Enclosed is our special performance audit of the Tobacco Settlement Investment Board. We have included your written response that, as you told the Board at its meeting held yesterday, February 23, would be finalized after the Board meeting.

We conducted this special performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained does indeed provide a reasonable basis for our findings and conclusions based on our audit objectives.

The audit report presents three findings and 17 recommendations. Each finding is broken down into discussion points that include the relevant details. Overall, as we note in the "Results in Brief" section of the report, the Tobacco Settlement Investment Board should be more transparent and accountable in its actions and decision-making, including initiating public discussions about the future of its declining Health Endowment Account that was intended to be a longer-term investment. The Board should also formalize some of its operating and investment procedures.

We appreciate the Board's acknowledgement of our findings and recommendations, and we expect that these findings and recommendations will help the Board in its transparency and accountability. The Tobacco Settlement Fund is critical to the funding of health-related programs such as tobacco use prevention and cessation, health research,

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health care insurance for the uninsured, home and community-based services for seniors, and medical care for workers with disabilities. As such, the Board's oversight is vitally important.

Thank you for the cooperation of the Board and its staff throughout our work on this audit.

Sincerely,

JACK WAGNER

Auditor General

Enclosure

cc: The Honorable Edward G. Rendell, Governor of Pennsylvania
Members, Tobacco Settlement Investment Board
Lauren Lenfest, Executive Director, Tobacco Settlement Investment Board

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**Results
in
Brief**

Overall conclusions

The Tobacco Settlement Investment Board (also referred to in this report as Investment Board or Board) should be more transparent and accountable in its actions and decision-making, including initiating public discussion about the future of its declining Health Endowment Account that was intended to be a longer-term investment. The Board should also formalize some of its operating and investment procedures. We have drawn the preceding conclusions following our special performance audit of the Pennsylvania Tobacco Settlement Investment Board as it manages the Tobacco Settlement Fund.

Background

The Tobacco Settlement Fund is a special revenue fund of the Commonwealth of Pennsylvania and was created by the Tobacco Settlement Act in 2001. The Tobacco Settlement Act resulted from the joint settlement agreement reached in November 1998 between five major tobacco companies and 46 states, including Pennsylvania, in which the states waged a four-year legal battle to recover past, present, and future Medicaid expenses for the treatment of tobacco-related illnesses. At the time of the settlement agreement, the full cost to the tobacco companies was projected to be \$206 billion, of which Pennsylvania was projected to receive about \$11.2 billion over 25 years.

As of June 30, 2008, the four accounts within the *overall* Tobacco Settlement Fund totaled \$1.2 billion as follows:

- \$64.9 million in the Health Venture Investment Account
- \$68.8 million in the Community Health Reinvestment Account
- \$456.4 million in the Tobacco Settlement Fund (an account of the same name within the overall fund)
- \$658.6 million in the Health Endowment Account for Long-Term Hope

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Responsibility for managing the Tobacco Settlement Fund falls to the eleven-member independent Tobacco Settlement Investment Board, created by legislation in 2001 and made up of gubernatorial and legislative appointees. This audit report is the result of our first special performance audit of the Investment Board. Our Bureau of Federal Audits conducted a financial statement audit of the Tobacco Settlement Fund for the fiscal year ended June 30, 2008.

Findings and Recommendations

We have identified three overall findings. **Finding One** addresses weaknesses related to the transparency and accountability of the eleven-member Board. In our first discussion point, we describe a lack of clarity in the Board's annual reports, as well as the Board's lack of public discussion related to the continued viability of the Health Endowment Account for Long-Term Hope created to sustain funding for health programs over the long term. Other discussion points describe a lack of readily accessible public information, limited public disclosure when Board members declared conflicts of interest, no written agreement with the Department of Community and Economic Development as that agency performed services for the Board, no formalized orientation and continuing education opportunities for Board members, and meeting minutes that were too abbreviated.

We present nine recommendations in Finding One. The Board has agreed to implement many of these recommendations, including the creation of a Web site, the development of an agreement with the Department of Community and Economic Development regarding the provision of services, formalized orientation and training programs, and more detailed meeting minutes.

In **Finding Two**, we discuss the fact that the Board did not have a consolidated policy and procedure manual for the administrative operations carried out by its staff. Despite having no consolidated manual, the staff generally adhered to

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Commonwealth requirements related to certain areas we reviewed, such as budget submissions and payments for Board and staff expenses. Regarding the procurement of investment consulting services, legal services, and due diligence services, we found that in some cases the Board's documentation was incomplete. According to the Board, the lack of completeness was primarily attributable to the fact that another agency contracted for the applicable services prior to the involvement of the Department of Community and Economic Development.

Our four recommendations address the need for a comprehensive policy and procedure manual, as well as the need to retain or obtain all documents related to procurement. The Investment Board has generally agreed with our recommendations.

In **Finding Three**, we discuss the lack of a consolidated policy document for both the Investment Board's investment guidelines and for its investment manager monitoring process. Again, however, we found that the Board did comply with various investment requirements, including the requirement that Health Venture Account investments were made mostly in Pennsylvania companies and in monitoring the investment earnings of the Life Sciences Greenhouse program. We also found that the Board participated in the process by which the investment consultant selected investment managers for the Board to hire.

Our four recommendations in Finding Three call for the Board to compile a comprehensive investment policy document, to formalize the monitoring process for investment managers, and to improve its annual reporting of certain investment information.

Audit Objectives, Scope, and Methodology

Our audit was conducted in accordance with generally accepted government auditing standards and covered the period of July 1, 2005, through June 30, 2008, with certain information

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updated through February 23, 2009. Our overall objective for this audit was to evaluate the Investment Board's oversight of the Tobacco Settlement Fund, and our more specific objectives, as well as our methodology, are detailed in Appendix A of this report.

The Tobacco Settlement Investment Board's written response to this audit is included in this report beginning on page 73. We have three comments regarding that response:

- Our recommendation #4 notes that the Board should better enforce and monitor compliance with the conflict of interest policy included in the bylaws. However, the Board's response notes that members have recused themselves even when recognizing an *appearance* of a conflict, that no instances were cited regarding failures to disclose conflicts, and that no instances were cited where the Board failed to monitor or enforce conflicts of interest. We acknowledge this response but, at the same time, believe the Board must go still farther in clarifying its conflict of interest policy as we detailed in our discussion and recommendation.
- Regarding our Discussion Point 3 in Finding Two, the Board disagrees with us that documentation related to emergency contracts was unclear. However, in one of the two instances we discuss with regard to legal services, the documentation simply stated there was an "emergency" without stating the reason for the emergency; in the second instance, even though there was more information, the reason for the "emergency" was still less than clear. Therefore, we stand by our discussion and recommendation.
- The response from the Board concurs with all remaining recommendations in the report.

Tobacco Settlement Investment Board *Introduction
and Background*

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Introduction and Background

The Tobacco Settlement Investment Board, referred to in this report as “Investment Board” or “Board,” is responsible for managing the Tobacco Settlement Fund, including investing and reinvesting fund monies for public health programs and initiatives.¹ The eleven-member Board includes the Governor or Governor’s designee, gubernatorial appointees, legislative appointees, and the Secretary of the Budget.² The Board is assisted by a three-member staff (executive director and two administrative officers³) and by staff from the Department of Community and Economic Development.

We notified the Investment Board of this special performance audit in August 2008 and held our audit entrance meeting with Investment Board staff in October 2008. Our overall objectives were to evaluate how the Board carried out directives of the Tobacco Settlement Act, and also to evaluate the Board’s oversight of the Tobacco Settlement Fund. The Tobacco Settlement Act and the Tobacco Settlement Fund are described in the following pages.

This audit is our first special performance audit of the Investment Board.⁴ The audit period is July 1, 2005, through June 30, 2008, with updated information through February 23, 2009, as available. We conducted this audit under the authority of The Fiscal Code⁵ and in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States. Appendix A discusses our objectives and methodology further.

¹ 35 P.S. § 5701.303.

² 35 P.S. § 5701.304(a).

³ The second administrative officer was hired in July 2008, which was after our primary audit period but before our field work began.

⁴ Our Bureau of Federal Audits has audited the Tobacco Settlement Fund every year since the Fund’s inception as part of the Comprehensive Annual Financial Report (CAFR). In addition, the Bureau of Federal Audits conducted a separate financial statement audit of the Tobacco Settlement Fund for the fiscal year ended June 30, 2008, and issued that report on December 23, 2008. For the fiscal year ended June 30, 2007, an outside auditing firm (with whom the Board contracted) conducted a financial statement audit of the Fund.

⁵ 72 P.S. §§ 402, 403.

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Master Settlement Agreement: Income to Pennsylvania

In November 1998, 46 states,⁶ including Pennsylvania, reached a joint settlement with five major tobacco companies, thereby ending a four-year legal battle in which the states sought recovery of past, present, and future Medicaid expenses for the treatment of tobacco-related illnesses. In 1994, Mississippi was the first state to sue the five companies—Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company, Philip Morris Incorporated, R.J. Reynolds Tobacco Company, and Commonwealth Tobacco. Pennsylvania filed suit in April 1997 and was the 24th state to do so.⁷

The joint settlement, which is known as the Master Settlement Agreement, obligated the five tobacco companies to pay each of the 46 states an annual sum for 25 years, beginning in June 2000.⁸ Each state's share of the total is determined by taking a variety of factors into consideration, including volume of tobacco product sales.⁹

When the Master Settlement Agreement was signed in 1998, Pennsylvania was projected to receive about \$11.2 billion in total payments. As of June 30, 2008, the state had received approximately \$3.5 billion in total, as shown in the table on the next page.

The Master Settlement Agreement also includes a provision for Pennsylvania and nine other states to receive ten separate and additional payments (called strategic contribution payments) from 2008 to 2017 to reflect the contributions made by those states toward the resolution of the lawsuits. Tobacco companies must place these payments into a separate strategic

⁶ Florida, Minnesota, Mississippi, and Texas had previously reached a combined \$40 billion settlement with tobacco manufacturers.

⁷ List of five tobacco companies is from the Master Settlement Agreement, Section II(hh), "original participating manufacturers," page 5. Reference to Pennsylvania as the 24th state is from *Physician's News Digest*, Christopher Guadagnino, Ph.D, August 2000, <http://www.physiciansnews.com/cover/800.html>.

⁸ The full cost to the tobacco companies over 25 years was projected to be \$206 billion to the 46 states.

⁹ Master Settlement Agreement, Section XI "calculation and disbursement of payments," page 44.

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contribution fund based on a formula developed by the states' attorneys general. Pennsylvania received its first strategic payment in April 2008 for \$25.8 million.¹⁰

Master Settlement Agreement: Payments to Pennsylvania	
Fiscal Year	Revenue Received
1999-00	\$ 464,554,000
2000-01	345,013,000
2001-02	433,529,000
2002-03	416,918,000
2003-04	370,857,000
2004-05	366,258,000
2005-06	336,227,000
2006-07	351,928,000
2007-08	<u>382,002,877</u>
Total to date = \$ 3,467,286,877	
Source: Governor's executive budgets (fiscal years 2001-02 through 2008-09) and Tobacco Settlement Fund financial statement audit report (fiscal year 2007-08). Note: Fiscal year 2007-08 includes \$25,846,904 strategic contribution payment received in April 2008.	

Establishment of the Tobacco Settlement Fund

On June 26, 2001, then-Governor Tom Ridge signed the Tobacco Settlement Act, Act 77 of 2001,¹¹ into law. This act mandated that the annual Master Settlement Agreement payments to the state must be deposited into the Tobacco Settlement Fund, a special fund of the Commonwealth.¹²

In addition to establishing the Tobacco Settlement Fund, the Tobacco Settlement Act established several accounts within the

¹⁰ Statement of Revenues and Expenditures and Changes in Fund Balances, June 30, 2008, Commonwealth of Pennsylvania Tobacco Settlement Fund audit report for the fiscal year ended June 30, 2008, as prepared by the Department of the Auditor General's Bureau of Federal Audits.

¹¹ 35 P.S. § 5701 *et seq.*

¹² 35 P.S. § 5701.303(a).

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Tobacco Settlement Fund. In the subsequent pages, we discuss several of those accounts, in particular the Health Endowment Account for Long-Term Hope and the Health Venture Investment Account.¹³

**Pennsylvania's use of the
Master Settlement Agreement proceeds**

The Master Settlement Agreement did not specify how each state must use the revenues it receives as a result of the agreement. However, Pennsylvania's Tobacco Settlement Act delineated how the annual tobacco settlement payments would be distributed from the Tobacco Settlement Fund.¹⁴ Each year, as part of the Commonwealth's appropriations process, the General Assembly appropriates tobacco settlement monies to the mandated state programs. The table below shows the programs and their funding for the last three fiscal years.

State programs funded with Tobacco Settlement Fund revenues			
State Program	FY 2005-06	FY 2006-07	FY 2007-08
Home and Community-Based Services	\$ 41,561,278	\$ 46,419,576	\$ 46,231,979
Tobacco Use Prevention and Cessation	30,711,546	28,440,073	31,004,799
Health and Related Research	69,408,721	63,448,686	66,328,322
Uncompensated Care	36,319,216	33,623,000	35,193,000
Health Investment Insurance	156,054,934	183,320,769	191,196,055
Medical Assistance Long-Term Care	57,230,000	66,120,000	104,810,000
PACENET Program	29,301,000	26,898,000	28,155,000
Life Science Greenhouses	<u>0</u>	<u>3,000,000</u>	<u>3,000,000</u>
Total State Program Expenditures	\$420,586,695	\$451,270,104	\$505,919,155
Source: Statement of Revenues and Expenditures and Changes in Fund Balances, Audited Financial Reports, for fiscal years ended June 30, 2006 through 2008.			

¹³ 35 P.S. § 5701.303(b), (c).

¹⁴ 35 P.S. § 5701.306(b).

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**Health Endowment Account for Long-Term Hope
(Balance as of June 30, 2008, was \$658.6 million)**

The Tobacco Settlement Act provides that, with few exceptions, all payments received by the Commonwealth as a result of the Master Settlement Agreement should be deposited into the Tobacco Settlement Fund,¹⁵ thereby resulting in revenues to fund the programs as shown above. Two significant exceptions are based on the Tobacco Settlement Act's establishment of the following accounts *within* the Tobacco Settlement Fund: the Health Endowment Account for Long-Term Hope,¹⁶ which we refer to as the Health Endowment Account or Endowment Account, and the Health Venture Investment Account.¹⁷

The Investment Board's annual reports over the years have made it clear that the Health Endowment Account was designed to be a long-term strategy by which the account would grow in order to sustain the public health programs currently paid for by the Tobacco Settlement Fund if and when the Master Settlement Agreement payments to that fund decrease or cease.

According to the Tobacco Settlement Act, the following deposits should be made to the Health Endowment Account:

- The initial payments (called jurisdictional payments) received by the Commonwealth pursuant to the Master Settlement Agreement.¹⁸
- The strategic contribution payments received by the Commonwealth pursuant to the Master Settlement Agreement.¹⁹

¹⁵ 35 P.S. § 5701.303(a).

¹⁶ 35 P.S. § 5701.303(b).

¹⁷ 35 P.S. § 5701.303(c).

¹⁸ 35 P.S. § 5701.303(b)(1).

¹⁹ 35 P.S. § 5701.303(b)(2).

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-
- Income that will be shared from Life Science Greenhouses once certain thresholds have been met.
 - Earnings derived from the investment of money in the Tobacco Settlement Fund after deduction of investment expenses.²⁰
 - Earnings derived from the investment of money in the Health Endowment Account itself after deduction of investment expenses and approved expenses of the board.²¹
 - Money received as a result of investments from the Health Venture Investment Account.²²

The Tobacco Settlement Act also provided that, each year, eight percent of that year's Master Settlement Agreement payment would be deposited into the Health Endowment Account.²³ That eight-percent payment would therefore be a consistent revenue source.

Regarding expenditures and transfers *from* the Health Endowment Account, that account is used each year (as indicated in the preceding third and fourth bullets) to pay the annual operating expenses of the board and its staff, and also to pay account investment expenses, such as fees paid to investment managers and advisors. Aside from those uses, the Tobacco Settlement Act provides that the Health Endowment Fund can be used “[w]henever the Governor determines that money from the Health [Endowment] Account is necessary to meet the extraordinary or emergency health care needs of the citizens of this Commonwealth”²⁴ In such a case, the Governor must present the General Assembly with a detailed spending proposal, and the General Assembly must approve

²⁰ 35 P.S. § 5701.303(b)(3).

²¹ 35 P.S. § 5701.303(b)(4).

²² 35 P.S. § 5701.303(b)(5).

²³ 35 P.S. § 5701.306(b)(1)(i).

²⁴ 35 P.S. § 5701.307.

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that proposal. Furthermore, after such redirection of funds, any monies not used would lapse and be returned to the Health Endowment Account.²⁵

The Investment Board's role with respect to overseeing and growing the Health Endowment Account includes the hiring of an investment consultant who, in turn, recommends that the Board approve an asset allocation plan. In implementing that plan, the Board hires various investment managers—recommended by the consultant—to achieve the best returns on the invested funds. Information about the Health Endowment Account investments is presented in an annual report prepared by Board staff, reviewed by Board members, and then submitted to the General Assembly.²⁶

**Health Venture Investment Account
(Balance as of June 30, 2008, was \$64.9 million)**

In addition to providing for the creation of the Health Endowment Account, the Tobacco Settlement Act created the Health Venture Investment Account, also referred to as the Health Venture Account or Venture Investment Account, and provided for a one-time appropriation (in 2001) of \$60 million into that account from the Tobacco Settlement Fund.²⁷ As with the Health Endowment Account, the Investment Board has a critical role, with exclusive control and authority to manage and invest money in the Health Venture Account.

The Investment Board's annual reports describe the Health Venture Account in part as representing a financial commitment to emerging life science businesses in Pennsylvania and to job creation. For example, the 2007-08 annual report says that the Health Venture Account "is fueling business growth in Pennsylvania by providing a critical financial resource" to these businesses, and that the

²⁵ *Id.*

²⁶ 35 P.S. § 5701.308.

²⁷ Former 35 P.S. §5701.5101(a)(2) (expired June 30, 2003).

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investments create pools of funds “that turn research and development into viable companies and jobs.”²⁸

The board selected four private venture firms to manage the Health Venture Account, thereby leveraging investments in Pennsylvania life science companies with the \$60 million appropriated to that account. These Pennsylvania firms and the amounts they were originally awarded are as follows:

- \$20 million to Quaker BioVentures (Philadelphia), which invests capital in biosciences companies located in the Mid-Atlantic region.
- \$20 million to Novitas Capital (Wayne), formerly known as Pennsylvania Early Stage Partners, to invest in seed, start-up, and early stage information technology and biosciences companies.
- \$10.8 million to Birchmere Ventures III (Pittsburgh) to focus principally on early-stage, pre-revenue start-ups in the Mid-Atlantic region.
- \$9.2 million to Commerce Health Ventures (Radnor), a diversified health care private equity fund focused on investing in the biopharmaceutical, medical device, and health care service sectors.

As of June 30, 2008, the four investment managers for the Health Venture Account had leveraged the initial \$60 million combined investment into more than \$450 million. According to the Tobacco Settlement Act, the liability of the Health

²⁸ *Pennsylvania Tobacco Settlement – Investing in the health of Pennsylvania*, Executive Summary, page 8, Annual Report 2007-2008, Pennsylvania Department of Community and Economic Development. Despite the Board’s status as an independent entity (more in Finding One, Discussion Point Four), we note that this annual report, plus the two reports that we reviewed from prior years, are identified as reports of the Department of Community and Economic Development and not of the Tobacco Settlement Investment Board.

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Venture Account is limited to the amount of its investment,²⁹ which Investment Board staff said is the original \$60 million.

As stated previously, money received as a result of investments from the Health Venture Account should be deposited into the Health Endowment Account.³⁰

The venture capital investments are long term; as of June 30, 2008, no transfers of earnings had been made from the Health Venture Account to the Health Endowment Account. The investments, the maturity dates, and the earnings are monitored by the investment managers, the investment consultant, and the Investment Board's executive director.

Life Sciences Greenhouse program

Stated simply, the Life Sciences Greenhouse program is intended to invest money into companies for the advancement of health care research and development. The program is so named because *life sciences*, such as biology, botany, biochemistry, ecology, medicine, and physiology, relate to living organisms, including human life and health, in contrast to *physical sciences* like astronomy and chemistry that study the inanimate universe. The "Greenhouse" terminology implies growth from seed, in this case start-up companies in the Commonwealth.

Unique to Pennsylvania, this program was set up in 2000 under then-Governor Tom Ridge and initially funded in April 2002 with \$100 million from the Tobacco Settlement Fund.³¹ The General Assembly appropriated this money to the Department of Community and Economic Development which, in turn, allocated the money as follows:

²⁹ 35 P.S. § 5701.305(f).

³⁰ 35 P.S. § 5701.303(b)(5).

³¹ The one-time appropriation of \$100 million to fund the Life Sciences Greenhouse program was established under former Section 5101(a)(2) of the Tobacco Settlement Act, 35 P.S. § 5701.5101(a)(2), which expired on June 30, 2003.

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- \$32.8 million to the Life Sciences Greenhouse of Central PA.
- \$33.8 million to BioAdvance, the Biotechnology Greenhouse Corporation of Southeastern PA.
- \$33.3 million to the Pittsburgh Life Sciences Greenhouse.

The three Greenhouse entities, which are closely connected to university research activities, provide money to applicant companies for the research and development of health-related technologies. This money is considered an investment in both economic development and human health because the funding can attract start-up companies, create high-technology jobs, and support the commercialization efforts for new products that have the potential to impact health. Furthermore, as explained by Investment Board staff, when certain thresholds have been met by these initiatives, the earnings can benefit the Health Endowment Account.

Examples of investments made with Life Sciences Greenhouse monies from the Tobacco Settlement Fund include these:

- A company developing safer drugs and a better way to bring new drugs to the market.
- A company developing hospital beds and patient care devices that will defend patients from hospital-acquired bacteria.
- A company developing equipment to help diagnose Alzheimer's disease, Parkinson's disease, and diabetes.
- A company developing artificial cartilage to use for minimally invasive joint repairs.

For the fiscal years of 2006-07 and 2007-08, the General Assembly appropriated \$3 million each year to the Life

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Sciences Greenhouse program from the Tobacco Settlement Fund. These appropriations were split among the three Life Sciences Greenhouses for operating and development activities for new start-up companies. Each of the three entities is subject to an annual performance review by the Department of Community and Economic Development, or DCED. According to Investment Board staff, DCED hired an independent contractor to conduct these reviews.

**Community health reinvestment:
basic health care for uninsured adults
(Balance as of June 30, 2008, was \$68.8 million)**

Via another account within the Tobacco Settlement Fund, the Board also is responsible for investing monies used by the state Insurance Department to assist in providing basic health insurance coverage (named “adultBasic”) for uninsured adults. According to Investment Board staff and other documents, an agreement to provide this assistance was reached in February 2005 between the Insurance Department and Blue Cross/Blue Shield plans, whereby the insurers would make annual payments—deposited into a restricted receipt account within the Tobacco Settlement Fund—for use only by the Insurance Department to provide this coverage.

Finding One

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**Finding One
The
Governing
Board**

The Tobacco Settlement Investment Board had several weaknesses specifically related to its governing Board, including annual reports that lacked clarity, little public information that was readily available, limited public disclosure regarding conflicts of interest, no written agreement with the Department of Community and Economic Development for its provision of administrative and staff resources, insufficient investment training, and abbreviated minutes of Board meetings.

In this section of the report, we present the details that led to the finding above. In particular, we discuss the following:

1. The Investment Board developed annual reports as required, but the reports lacked clarity and did not analyze the continued viability of the Health Endowment Account that was created to sustain health programs over the longer term.
2. The Investment Board offered limited public information that was readily accessible (e.g., Web site, other communications) regarding the Tobacco Settlement Fund, the fund accounts, fund investments, the governing Board, the Board's activities, and the administrative staff.
3. The Investment Board provided limited disclosure when members declared conflicts of interest and also did not have a process to follow up with members if they did not complete statements of ethics.
4. The Investment Board had no written agreement³² with the Department of Community and Economic Development regarding services performed by DCED staff and the use of other DCED resources.

³² Such an agreement would include a memorandum of understanding between the Investment Board and DCED, similar to those agreements used by other state agencies, commissions, and boards.

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5. The Investment Board provided new member orientation informally and offered opportunities for continuing education but did not formalize these activities so that the public can be confident regarding the Board's investment knowledge.
6. The Investment Board publicly announced its meetings and opened them to the public, but it kept meeting minutes that were too abbreviated.

The methodology we used to develop this finding and the related discussion points includes our completion of the following tasks:

- Reviewed the Tobacco Settlement Act and bylaws for the Investment Board, and Investment Board's staff requirements.
- Reviewed minutes of Investment Board meetings.
- Conducted research to determine the availability of public information on the Investment Board and the Tobacco Settlement Fund.
- Attended an Investment Board meeting in November 2008 and February 2009.
- Interviewed staff of the Investment Board, the Department of Community and Economic Development, the State Ethics Commission, and the Governor's Office of Administration.
- Requested and reviewed voting recusal forms.
- Reviewed the Investment Board's annual budget.
- Accessed the State Ethics Commission's Web site to obtain statements of financial interest.

Our discussion in the pages that follow shows, in accordance with government auditing standards, how our audit work provides reasonable assurance that evidence is sufficient and appropriate to support our finding and to draw the conclusion that the Tobacco Settlement Investment Board could have been far more transparent and accountable with regard to the actions and decision-making of its governing board.

Finding One

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**Discussion
point 1**

The Investment Board developed annual reports as required, but the reports lacked clarity and did not analyze the continued viability of the Health Endowment Account that was created to sustain health programs over the longer term.

The Tobacco Settlement Act requires the Investment Board to submit an annual report to the Governor and the Appropriations Committees of the Senate and the House of Representatives by November 30 of each year. This report “shall provide an analysis of the status of the current investments and transactions made over the last fiscal year for the fund and the accounts.”³³

After obtaining the annual reports for the fiscal years ended June 30, 2006, through June 30, 2008, we found that the reports were dated prior to the annual November 30 deadline, and that each report comprised several hundred pages divided into sections: an overall executive summary, reports from the three Life Sciences Greenhouses and from the four Health Venture Account investment managers, an executive summary of investment performance, and the investment consultant’s review of manager objectives and manager performance against these objectives.

We previously described several accounts within the overall Tobacco Settlement Fund, such as the Health Endowment Account for Long-Term Hope and the Health Venture Investment Account. It is the Health Endowment Account on which we focused after observing that the annual reports did not discuss the continued viability of that account. In particular, even though the reports could arguably be said to provide “an analysis of the status of the current investments and transactions made over the last fiscal year for the fund and the accounts” as required, the information was neither clear nor

³³ 35 P.S. § 5701.308.

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precise, and the “analysis” specifically did not address the lifespan of the Endowment Account.

Beginning with the annual report for the fiscal year ended June 30, 2006, we reviewed what each of the annual reports had to say (or not say) about the Health Endowment Account.

- **Too little information.** Despite the volume of each report, the sections titled “Health Endowment for Long-Term Hope” were remarkably truncated—five paragraphs in 2005-06 and 2006-07, and three shorter paragraphs in 2007-08. In each of the reports, one of the paragraphs did note—without analysis—that annual legislation had resulted in transfers from the account, and also in transfers not being made to the account.
- **Earnings disclosed, but not the declining endowment balances unless readers knew exactly where and how to look.** Absent from the discussion of “Health Endowment for Long-Term Hope” were annual Endowment Account balances. Average earnings since inception were reported—9.3 percent in 2005-06, 11 percent in 2006-07, and 7 percent in 2007-08.

Nowhere in the reports would readers find a balance by the name of “Health Endowment Account,” “Endowment Account,” or even just “Endowment.” Instead, in the investment consultant’s executive summary of investment performance, we located the balance—labeled either “Total assets” (2005-06 and 2006-07) or “Total fund” (2007-08). In that way, the balances were reported as shown next:

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Health Endowment Account for Long-Term Hope:		
Declining account balances were hard to locate in annual report, but the balances were reported as shown below.		
Annual Report	Balance labeled as:	Balance listed as:
2005-2006	Total Assets	\$729,842,000 (as of June 30, 2006) ³⁴
2006-2007	Total Assets	\$716,934,000 (as of June 30, 2007) ³⁵
2007-2008	Total Fund	\$658,580,000 (as of June 30, 2008) ³⁶
Balance declined by \$71.3 million over the three years		

- **No report of deposits and withdrawals.** The reports also did not list the deposits and withdrawals into and out of the Endowment Account. Nonetheless, we were able to determine from other sources that the account's decline was not limited to the three-year decline of \$71.3 million shown in the table above. Specifically, by using financial information that we obtained from the Comptroller's Office, we calculated that the account

³⁴ Pennsylvania Tobacco Settlement Annual Report 2005-2006, Executive Summary of Investment Performance, quarter ending June 30, 2006, page 8.

³⁵ Pennsylvania Tobacco Settlement Annual Report 2006-2007, Executive Summary of Investment Performance, quarter ending June 30, 2007, page 7.

³⁶ Pennsylvania Tobacco Settlement Annual Report 2007-2008, Executive Summary of Investment Performance, quarter ending June 30, 2008, page 10.

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had missed out on *at least* \$112.1 million since fiscal year 2002-03—both by giving away its earnings *to* the Tobacco Settlement Fund, and by giving up the receipt of earnings *from* the Tobacco Settlement Fund. In short, the Endowment Account had been unable to earn interest on this \$112.1 million, or to build further equity with that amount.

- **Account usage.** Annual budget acts³⁷ had mandated the transfers of earnings *from* the Endowment Account (including certain lapsed funds that the Endowment Account had received in prior years), and had also prohibited the transfers of earnings *to* the Endowment Account. References were made to these legislatively required actions in the truncated “Health Endowment for Long-Term Hope” section that we described previously. Yet only the 2005-06 and 2006-07 reports indicated how the earnings were used, albeit in the most general terms—i.e., “to support healthcare programs for Pennsylvanians,” echoing the budget acts.
- **Endowment Account lifespan.** Both the 2005-06 and 2006-07 reports indicate a 25-year lifespan, but there is no mention of lifespan in the 2007-08 report.

The chart on the next page provides additional details, along with our comparative analysis of the information that the Investment Board had included in each annual report under the brief section, “Health Endowment for Long-Term Hope.”

³⁷ See former 72 P.S. § 1721-A (expired July 1, 2006) (Act 41 of 2005) and 72 P.S. § 1715-C (Act 66 of 2006).

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Our comparative analysis of the discussion from one report to the next ↓	Health Endowment Account – When read carefully, the discussion in annual reports from one year to the next reflects a declining lifespan		
	2005-06 Report <i>Fiscal year ended 6/30/06</i> (pp. 7-8, Executive Summary)	2006-07 Report <i>Fiscal year ended 6/30/07</i> (p. 7, Executive Summary)	2007-08 Report <i>Fiscal year ended 6/30/08</i> (p. 9, Executive Summary)
Note that “equity” strategy was later called “investment” strategy; also, “can generate sufficient earnings” was later changed simply “to support.” These changes occurred as the account began to be used rather than to be built up	“The Health Endowment . . . was designed to be a long-term equity strategy to provide for the sustainability of health-related programs the Master Settlement Agreement (MSA) may not have the ability to support in future years. The Endowment is therefore being built to a size that can generate sufficient earnings to underwrite the existing programs when the annual payments under the MSA are no longer adequate.”	“The Health Endowment . . . was established in the enabling legislation in 2001 and receives 8 percent of the payments made under the Master Settlement Agreement (MSA). . . . [I]t is a long-term investment strategy focused on return to support health related funding in future years.”	
“[T]otal equity investment” became just “investment activity” after spending started	“. . . Board approved a strategy for total equity [in] investment . . . for long-term growth.”	“. . . Board approved a strategy for investment activity . . . for long-term growth.”	
Endowment Account gave its own earnings to the Tobacco Settlement Fund instead of vice versa as provided by Act 77 of 2001	Endowment received 8% of MSA payment, or \$26.9 million, in accordance with Act 77 of 2001, but did NOT receive earnings from the Tobacco Settlement Fund as Act 77 provided. The account also gave last year’s earnings to the Tobacco Settlement Fund.	Endowment Fund received 8% of MSA payment, or \$28.5 million, in accordance with Act 77 of 2001.	
In the 2007-08 report, there is no mention of the Endowment Account’s lifespan.	Endowment is “at the fourth year of the 25-year-long strategy.” Returns are expected to increase as the Endowment becomes more fully invested. . . .”	Endowment “is ramping up” to see the potential of its 25-year strategy. Increased returns are expected as the account is “more fully invested. . . .” [nothing mentioned]	

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In the Commonwealth's proposed budget for 2009-10, there are continued plans for "redirecting" funds that the Tobacco Settlement Act originally intended for the Health Endowment Account, including the 8 percent portion of the annual Master Settlement Agreement payment, the second of 10 annual strategic contribution payments discussed earlier in this report, and the earnings from the Endowment Account and the Tobacco Settlement Fund. According to the proposed budget, the 8 percent portion would be redirected "to support health-related expenditures,"³⁸ which are described elsewhere in the proposed budget as "long-term care services"³⁹ and, in reference to prior years, as redirections "to fund the escalating cost of long-term care services for persons with disabilities and seniors."⁴⁰ Regarding the redirection of the strategic contribution payment, the budget document says only that the budget "proposes to continue to redirect strategic contributions from the Health Endowment for Long-Term Hope to the Tobacco Settlement Fund."⁴¹

Finally, that same budget document shows "0" estimated revenue for the Health Endowment Account for fiscal years 2010-11, 2011-12, 2012-13, and 2013-14.⁴²

In summary, we found that, although the Health Endowment Account was not always used as Act 77 of 2001 had provided, redirections of account monies were made in accordance with budget acts passed by the General Assembly. Therefore, the Investment Board was compelled to redirect these funds. What the Investment Board could have done additionally, however, was to provide clarity and public discussion about the Health Endowment Account and its future.

³⁸ 2009-10 Governor's Executive Budget, Edward G. Rendell, Governor, Commonwealth of Pennsylvania, page C12.5.

³⁹ 2009-10 Governor's Executive Budget, page C12.2.

⁴⁰ 2009-10 Governor's Executive Budget, page C12.2.

⁴¹ 2009-10 Governor's Executive Budget, page C12.6.

⁴² 2009-10 Governor's Executive Budget, page C12.7.

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Recommendations

1. The Investment Board should be more transparent and accountable in its annual reports, especially in providing information about accounts such as the Health Endowment Account and in discussing the continued viability of that account.
2. The Investment Board should continue to submit its annual reports by November 30 of each year as required. At the same time, the Investment Board should present its investment analyses clearly, concisely, and in a reader-friendly manner.

**Discussion
point 2**

The Investment Board offered limited public information that was readily accessible (e.g., Web site, other communications) regarding the Tobacco Settlement Fund, the fund accounts, fund investments, the governing Board, the Board’s activities, and the administrative staff.

The Tobacco Settlement Act gives the Investment Board exclusive control and authority to manage, invest, and reinvest money in the Tobacco Settlement Fund and the Health Endowment Account.⁴³ Further, the members of the Investment Board and the professional personnel “stand in a fiduciary relationship to the Commonwealth and its citizens regarding the investments of the money of the Fund and the accounts....”⁴⁴

The specific composition of the Investment Board⁴⁵ is as follows:

- the Governor, or the Governor’s designee
- three members appointed by the Governor

⁴³ 35 P.S. § 5701.305(a).

⁴⁴ 35 P.S. § 5701.305(b).

⁴⁵ 35 P.S. § 5701.304(a).

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- the Secretary of the Budget
- two members appointed by the President pro tempore of the Senate
- one member appointed by the Minority Leader of the Senate
- two members appointed by the Speaker of the House of Representatives
- one member appointed by the Minority Leader of the House of Representatives⁴⁶

The six legislative appointees serve at the pleasure of the appointing authority, and the Governor's three appointees serve for a term of four years and until a successor is appointed. Investment Board members serve without compensation, but are reimbursed for reasonable expenses incurred in the performance of their duties.⁴⁷

The Tobacco Settlement Act allows the Investment Board to hire staff "as the board deems advisable."⁴⁸ During most of the period we reviewed, the Investment Board's staff consisted of two employees—an executive director and an administrative officer—whose combined salaries totaled \$144,783 (not including benefits) for fiscal year 2007-08. In the summer of 2008, an additional administrative officer was added. These employees carry out day-to-day administrative duties of managing the Tobacco Settlement Fund, monitoring investment activity, and ensuring compliance with Investment Board directives and Tobacco Settlement Act requirements.

Prior to and throughout our audit work, we conducted research about the Investment Board and the Tobacco Settlement Act in order to understand the nature and profile of the overall

⁴⁶ The Tobacco Settlement Act originally provided for the State Treasurer or a designee to be a member of the board as well as for the State Treasurer to appoint a member to the board. An amendment to the Tobacco Settlement Act through Act 149 of 2002 eliminated the provision for these two members and changed the appointments by the President pro tempore of the Senate and the Speaker of the House of Representatives from one each to two.

⁴⁷ 35 P.S. § 5701.304(a).

⁴⁸ 35 P.S. § 5701.304(b).

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program. In addition to general online research, for example, we also searched specific Pennsylvania government sites, including legislative sites.

We found less public information than we expected to find when we looked for information identified as coming from the Investment Board itself. For example, as recently as February 2009, we had found no specific Web site for the Investment Board, or lists of the board members, governing board bylaws, board meeting schedules and/or agendas, board meeting minutes, annual reports, audited financial statements, management reports, investment reports, or investment policies. Further, no Web site addresses or Internet links were provided to guide us to sites where we could locate any such information about the Board.

We also found that the Investment Board had no brochures, pamphlets, or other information available to the public.

What we *could* find about the Investment Board easily, particularly online, was information published by others. To cite several examples, we found a news release issued by a legislator after he was named to the Investment Board,⁴⁹ or information in a budget briefing posted by the chairman of the House Appropriations Committee,⁵⁰ and occasional news articles in various media.

With the Commonwealth receiving nearly \$400 million each year from tobacco companies according to the terms of the Master Settlement Agreement, and with the General Assembly appropriating nearly \$500 million from the Tobacco Settlement Fund each year for state health, insurance, aging, and welfare programs, it is incumbent upon the staff of the Investment

⁴⁹ News release, May 27, [2008]. "Shapiro Appointed to Tobacco Settlement Investment Board," <http://www.pahouse.com/PR/153052708.asp>. Verified February 11, 2009.

⁵⁰ February 21, 2008. *Report on Key Issues from the House Appropriations Committee - Budget Briefing*, Dwight Evans, Democratic Chairman, <http://www.hacd.net/budget/200809/documents/bbtobacco022108.pdf>. Accessed February 5, 2009. Verified February 11, 2009.

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Board to provide the public and others with information about the governing board and its activities.

Regarding information about the Tobacco Settlement Fund and its accounts and investments, we note the General Assembly appropriated more money *from* the Tobacco Settlement Fund each year of our audit period than the Fund *received* in annual settlement payments from the tobacco companies. Therefore, because annual appropriations that exceed earnings will eventually lead to an inability to fund services, Commonwealth citizens should be able to keep themselves informed and updated on the Investment Board's activities. To that end, citizens should have easy access to accessible and user-friendly Web site, annual reports, financial statements, investment results, board meeting minutes, and any other information that will make the Investment Board transparent and therefore more accountable to the public.

In contrast to the scarcity of information that the Investment Board offers publicly, the Pennsylvania State Employees' Retirement System, or PSERS, provides extensive information on its Web site alone. We compared the Investment Board and PSERS because of their similarities—e.g., like the Investment Board, PSERS is also responsible for the investment, reinvestment, and management of billions of dollars for the future benefit of Commonwealth citizens.

Specific types of information that is posted for the public's review on the PSERS Web site⁵¹ includes the following:

- Investment policy statement, and objectives
- Investment guidelines for 11 different investment programs
- Overview of the investment program
- Roster of investment managers, advisors, and partnerships

⁵¹ <http://www.psers.state.pa.us/invest/invest.htm>. Accessed on January 13, 2009. Verified February 20, 2009.

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- Comprehensive annual financial reports for the past ten fiscal years
- Current press releases on investment performance
- Schedule and summaries of PSERS board meetings
- Annualized investment performance statement
- Investment guidelines

When we presented this finding to the Investment Board staff in early February 2009, the staff agreed that a Web site was long overdue and that such a site is critical to communicate information about the board and its actions. Moreover, the staff explained that Web-page development had begun in the fall of 2008 and that, in fact, the staff would demonstrate the design and functionality of such a Web page at the board's next meeting. Via documents that the staff then provided to us, we confirmed that the Web-page development was under way. Furthermore, on February 20, 2009, Investment Board staff provided us with a demonstration of the Web site so that we could see that the content parallels our recommendation.

Recommendation

3. The staff of the Investment Board should finalize its development of a Web site that can be accessed through a general Web search and from the Commonwealth's home page. Staff should ensure that this Web site, at a minimum, include the following information:
 - a. An overview of the creation and purposes of the Investment Board, the Tobacco Settlement Fund, and its accounts
 - b. Names of the Investment Board members and staff with biographies
 - c. Investment Board bylaws
 - d. Investment Board meeting dates
 - e. Investment Board meeting minutes
 - f. Investment Board meeting transcripts
 - g. Annual reports
 - h. Audited financial statements

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- i. Management reports
 - j. Investment policy statement, objectives, and guidelines
 - k. Press releases on investment performance
-

**Discussion
point 3**

The Investment Board provided limited disclosure when members declared conflicts of interest and also did not have a process to follow up with members if they did not complete statements on ethics.

As we discussed previously, the Investment Board includes a total of 11 elected and appointed officials. As trustees of the Tobacco Settlement Fund, these officials—and their staff—have a fiduciary responsibility to the Commonwealth and its citizens:

The members of the board and their professional personnel shall stand in a fiduciary relationship to the Commonwealth and its citizens regarding the investments of the money of the [Tobacco Settlement] fund and the accounts and shall not profit, either directly or indirectly, with respect thereto.⁵²

Recognizing this critical fiduciary responsibility of the Investment Board and its staff, the Investment Board issued statements in its bylaws related to conflicts of interest. Specifically, the bylaws state that “the Public Official and Employee Ethics Act⁵³ is applicable to the Board and to the members thereof in accordance with its terms.” The bylaws

⁵² 35 P.S. § 5701.305(b).

⁵³ 65 Pa.C.S. § 1101 *et seq.*, hereafter referred to as the Ethics Act.

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also state that the Governor's Code of Conduct⁵⁴ is applicable to the Governor's appointees to the Investment Board.

While the bylaws state that both the Ethics Act and the Governor's Code of Conduct apply to the Investment Board members, as applicable,⁵⁵ the board has not formalized procedures that outline the actions board members and staff must take to eliminate conflicts of interest. Nor has the Investment Board clearly defined what would constitute a conflict of interest, including a dollar threshold.

The issue of conflict of interest is important because the Investment Board members make critical decisions on Tobacco Settlement Fund investments based on information provided by an investment consultant. In turn, the investment consultant relies heavily on the business practices of investment managers who select investment instruments, including venture capital organizations that rely on invested money for full development. Both this chain of reliance and the use of taxpayer dollars create the need to pay rigorous attention in identifying potential and actual conflicts of interest between the various people and entities, thereby maintaining the Investment Board's independence and preserving integrity and public confidence.

We asked staff from the Investment Board and the Department of Community and Economic Development how they can be assured that Investment Board members act in a truly fiduciary manner as they oversee the Tobacco Settlement Fund. The response included several points: (1) Investment Board members are responsible for disclosing conflicts of interest in their annual State Ethics Commission statements of financial interest; (2) Investment Board members are required to recuse from voting on any matter that would result in a conflict of interest; and (3) Investment Board members are supposed to

⁵⁴ 4 Pa. Code §§ 7.151-7.179 (relating to Code of Conduct of Appointed Officials and State Employees), hereafter referred to as the "Governor's Code of Conduct." See also Executive Order 1980-18 Amended, entitled, "Code of Conduct," dated May 16, 1984.

⁵⁵ Please note that the legislative members are subject to the Legislative Code of Ethics, 46 P.S. § 143.1.

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complete a recusal form stating the reason for the recusal. While we found these points to be reasonable, we also found that no one is responsible for reviewing the statements of financial interest to determine potential conflicts and no one is responsible for investigating any such conflicts.

We also found that not all Investment Board members had statements on file with the State Ethics Commission, despite our having been told by the staff that the statements were the primary means of ensuring that Investment Board members disclose any conflicts.⁵⁶

In order to determine whether all Investment Board members had completed their statements, we accessed the State Ethics Commission's Web site, which allows public access to all statements of financial interest filed by public officials in the past five years. We searched for statements filed by each Investment Board member and by any designee for the calendar years 2005, 2006, and 2007, the three years of filings available for our audit period.

As the result of this work, we found that most Investment Board members and all designees had statements on file with the State Ethics Commission. However, there were two exceptions—an Investment Board member who had no statement on file for 2007, and a second member with no statements on file for any year of our review. In response to our questioning, the Ethics Commission directed us to the Investment Board. Upon our request, the Investment Board's staff provided us with the 2007 statement from the one board member. However, staff from the human resources area of the Department of Community and Economic Development told us

⁵⁶ Investment Board members and staff are required to complete the statements annually by May 1 and disclose financial information for the previous calendar year. Because Investment Board members are considered to be public *officials* under the Ethics Act, their original completed statements must be submitted to the State Ethics Commission. Staff members are considered to be public *employees*, and their original completed statements are kept on file at the human resource office of their agency, which in this case is the Department of Community and Economic Development.

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that all statements of financial interest for the second board member were “missing.”

Unlike the board members, who are not compensated for their services, Investment Board staff members are required to complete an additional form besides the one for the Ethics Commission. The Governor’s Code of Conduct statement of financial interest requires detailed annual disclosure of issues such as personal economic interests, business interests, liabilities, employment, real property interests, severance payments, and gifts.

We reviewed the statements of financial interest and Governor’s Code of Conduct forms of the Investment Board staff and found statements and forms for all years of our audit period.

In addition to reviewing statements of financial interest, we also attempted to obtain assurance that any potential conflicts of interest were properly divulged at Investment Board meetings. This divulging of conflicts can occur in various ways, according to Investment Board staff, including requiring Investment Board members to recuse from voting on any matter that would result in a conflict of interest. The requirement is set forth in the Investment Board’s bylaws, which also state that Investment Board members must “refrain from participating in any discussions concerning the matter, and, prior to the vote being taken, publicly announce and disclose the nature of his or her interest *as a matter of public record.*”

In our review of the Investment Board meeting minutes for our three-year audit period, we found four recusals by board members regarding voting. However, the minutes we reviewed only summarized the meetings and were not actual transcripts, and these summaries included no reasons for the recusals. In fact, in two instances, the meeting minutes did not even identify the Investment Board members who recused themselves.

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We attempted to find more details by asking to review actual meeting transcripts, but Investment Board staff explained that such transcripts are destroyed after the meeting minutes are completed, that the summaries serve as the official minutes and record of meetings, and that the summaries are the only such documents that the Investment Board retains. This lack of detailed minutes is particularly significant when we consider that the four recusals related to Investment Board decisions involved almost \$18.2 million in public funds.

We conducted further examination by requesting copies of all recusal forms, which as we already noted must be completed by board members who recuse themselves from voting. Of the four recusals, only one actually matched a recusal that was documented in the minutes. The other three recusal forms did not provide enough information for us to confidently match them with a recusal stated in the board meeting minutes. Furthermore, the reasons cited on the four recusal forms were too brief and too vague to supply enough information for analysis. For example, one recusal form indicated simply that the Investment Board member had a “Relationship with one of the respondents to the RFQ [Request for Quotation].” That same form—which the Investment Board member left unsigned—included a handwritten note questioning the need for the form because “[t]he minutes should show that I abstained.” However, our review of the minutes showed they did *not* show any recusal.

Overall, we found that voting recusal forms were not used consistently, and that they provided insufficient details to show why Investment Board members recused themselves. We also concluded that the Investment Board and staff could have been more proactive in their review of recusal forms and official meeting records to prevent conflicts of interest from occurring.

At the Investment Board’s meeting on November 17, 2008, we learned that staff had recently developed a fiduciary acknowledgement letter for signature by Investment Board members. In signing this form, board members would thereby

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acknowledge their fiduciary responsibilities, the absence of conflicts of interest, and the receipt of applicable Commonwealth management directives plus the Web addresses to access those directives. However, we also learned that the forms are voluntary, not required, and would serve only as an administrative tool. The Investment Board should be concerned by this voluntary usage because, even though the form does not replace a written conflict of interest policy itself, the form is still better than nothing. In particular, in reviewing a blank form, we judged it to serve a useful purpose in reminding Investment Board members of their fiduciary roles and the “special relationship of trust, confidence, and/or legal responsibility”⁵⁷ to the public.

Recommendations

4. The Investment Board should better enforce and monitor compliance with the conflict of interest policy that is included in the bylaws and, in fact, should clarify its policy in defining such conflicts as they relate to the fiduciary duty of Investment Board members. For example, the Board should establish a minimum dollar amount that would trigger disclosure of conflicts, describe the circumstances under which disclosures should occur, require members to disclose orally and in writing the nature and details of potential conflicts/recusals, and require staff to include such details in the meeting minutes.
5. The Investment Board should require that all board and staff members complete and file their statements of financial interest; the Board should also require that an appropriate designee perform periodic reviews of the statements of financial interest to identify and resolve potential problems.

⁵⁷ Investment Board’s *Fiduciary Acknowledgement* form provided by the Board staff on January 16, 2009.

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**Discussion
point 4**

The Investment Board had no written agreement with the Department of Community and Economic Development regarding services performed by DCED staff and the use of other DCED resources.

When the Investment Board was created in 2001, it was first placed under the Governor's Office of Administration. At that time, the Investment Board hired no staff but instead relied on staff of the Office of Administration for needed services. On June 24, 2003, the Office of Administration entered into a memorandum of understanding with the Department of Community and Economic Development, also referred to as DCED in this memorandum, for the transfer of Investment Board staff services from the Office of Administration to DCED.

This memorandum of understanding, which was effective from July 1, 2003, to June 30, 2004, and is therefore now expired, stated that "DCED has agreed to provide staff services to the Board to assist the Board in administering the Act, provided DCED receives additional funding and complement slots to effectively carry out these duties." The Office of Administration agreed to transfer \$276,000 to DCED so it could provide staff services, but current Investment Board staff said that this transfer of dollars never occurred.

During the same fiscal year in which the memorandum of understanding was effective, the Investment Board hired its first executive director. However, even with that hiring and the subsequent hiring of an administrative officer, the Investment Board still received additional staff services from employees of the Department of Community and Economic Development. Such services included budgeting, information technology, human resources, and legal services. In addition, DCED also provided and charged the Board for office space, office furniture, and supplies, as well as for legal services. For example, DCED billed the Investment Board for the partial

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salaries and benefits—between 2 and 25 percent—of approximately six persons from the DCED Legal Office. Each year the DCED Chief Counsel determined the allocation percentage for each legal office employee based on the needs of the Investment Board. These legal staff costs were included in the Investment Board’s total personnel cost figure in its annual budget.

Without an agreement—for example, a memorandum of understanding—between the Investment Board and DCED, the two entities could not know precisely which entity was responsible for what. The Investment Board should be concerned about this lack of clarity because the board was created to be independent,⁵⁸ and a clearly defined division of responsibilities is therefore critical.⁵⁹

Following are some examples of DCED’s overlap with the Investment Board:

- When we met with the Investment Board’s executive director for our audit entrance conference, the following DCED staff also participated: the deputy secretary for technology investment, the chief counsel, and the director for audits and compliance.
- The position description for the Investment Board’s executive director lists DCED’s deputy secretary for technology investment as her supervisor when, in fact, she reports to the Investment Board.
- The DCED chief counsel attended all audit meetings.
- When we submitted written information requests to the Investment Board’s executive director, we did not receive written responses and other documents until

⁵⁸ 35 P.S. § 5701.304(a); 35 P.S. § 5701.305(a)-(b).

⁵⁹ In information provided to the Department of the Auditor General from the Investment Board on February 3, 2009, the board staff stated that a memorandum of understanding between the Investment Board and DCED will be presented for board approval at the February 2009 Investment Board meeting.

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such materials were reviewed by the following DCED staff: the chief counsel, the deputy secretary for technology investment, and personnel from the bureau for audits and compliance.

- The Investment Board’s annual budget has not been submitted independently to the Office of the Budget; rather, it has been included as a section with DCED’s overall agency annual budget.⁶⁰
- At the November 17, 2008, Investment Board meeting, DCED’s deputy secretary for technology investment sat at the conference table with the Investment Board members and the Investment Board’s executive director. According to Investment Board staff, while the deputy secretary is not part of either the Investment Board or its staff, he is considered “a resource for the board.”
- Some of the letters of agreement between the Investment Board and the provider of due diligence services are on DCED letterhead, not Investment Board letterhead; yet these letters are signed by the Investment Board’s executive director.
- The Investment Board’s executive director also performs work directly for DCED in overseeing the Life Sciences Greenhouse program investments.

In looking at the Tobacco Settlement Act, we found no reference about DCED or any other state agency having a role with the Investment Board. Instead, as stated earlier in this

⁶⁰ Under Section 304(c) of the Tobacco Settlement Act, 35 P.S. § 5701.304(c), the Investment Board “shall, through the Governor, submit to the General Assembly an annual budget covering its proposed administrative expenses. Concurrently, with its annual budget request, the board shall submit to the General Assembly a list of proposed expenditures for the period covered by the budget request that the board intends to pay through the use of directed commissions, together with a list of the actual expenditures from the previous year actually paid by the board through the use of directed commissions.”

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report, we found that the Investment Board may *employ staff*,⁶¹ which it did with the hiring of the executive director in 2003, the administrative officer in 2004, and the subsequent administrative officer in the summer of 2008.

Overall, we found that DCED’s involvement with the Investment Board had the distinct appearance of making the board seem dependent on the DCED staff. Stated another way, the Investment Board’s public accountability as an independent entity was jeopardized because others outside the Investment Board could perceive that it was an appendage of DCED and accountable to it.

Recommendation

6. The Investment Board should enter into a memorandum of understanding with DCED to spell out the services that DCED will provide to the board, as well as boundaries that must be observed to avoid conflicts of interest and appearances of impropriety.

**Discussion
point 5**

The Investment Board provided new member orientation informally and offered opportunities for continuing education but did not formalize these activities so that the public can be confident regarding the Board’s investment knowledge.

As fiduciaries of the Tobacco Settlement Fund, Investment Board members and their designees are expected to understand the issues and concerns facing the Tobacco Settlement Fund so that the Investment Board can develop, implement, and monitor policies to guide the investment of Tobacco Settlement Fund monies. Therefore, it is imperative that the Investment Board members are adequately oriented and educated with

⁶¹ 35 P.S. § 5701.304(b). This section allows the Investment Board to “employ investment advisors, fund managers and staff as the board deems advisable.”

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regard to investing so that they may fulfill their fiduciary responsibilities.

We found that the Investment Board did not provide a formal training or orientation to its members, nor did it require investment training in particular. However, the Investment Board staff vigorously defended the lack of required training and noted not only that board members are appointed based on their existing education, knowledge, and experience, but also that their existing backgrounds have been sufficient to carry out the members' duties.

Investment Board staff further noted that, although there is no written documentation, the staff provides Board members with several hours of orientation, including a review of the Board's bylaws, meeting minutes, legislation, and annual reports. Furthermore, the staff was adamant that Board members routinely benefit from the presentations by investment managers at Board meetings, from the dialogue at those meetings, and from routinely distributed communications regarding past, current, and proposed investments.

Based on the importance of the Tobacco Settlement Fund and its investments, the Investment Board should recognize the need for staff to formalize the orientation program, to better document the continuing education that results from the routine Board meetings, and to offer, encourage, and document further participation in continuing education activities. Not only is it critical for members to have these opportunities and to participate in them, but it is equally important for the public to *know* (hence the need for formalization and documentation) that the members are capable in this regard, including members who already have extensive investment knowledge and experience.

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Recommendation

7. The Investment Board staff should develop, with the board’s approval, a formal board member orientation program. Furthermore, the Board should require that staff offer, encourage, and document the Board’s participation in continuing education activities and opportunities with regard to investments.

**Discussion
point 6**

The Investment Board publicly announced its meetings and opened them to the public, but it kept meeting minutes that were too abbreviated.

The purpose of the state Sunshine Act⁶² is to ensure the right of all Commonwealth citizens to have notice of and to attend all meetings of state agencies. Further, the Sunshine Act was enacted because it is vital to the “enhancement and proper functioning of the democratic process and that secrecy in public affairs undermines the faith of the public in government....”⁶³

The Sunshine Act outlines rules for agency open meetings, including the following:

- Public notice must be given for all meetings, which includes publication of the meeting notice in the newspaper and posting the meeting notice at the principal office of the agency holding the meeting.⁶⁴
- The vote of each member must be publicly cast.⁶⁵

⁶² 65 Pa.C.S. § 701 *et seq.*

⁶³ 65 Pa.C.S. § 702(a).

⁶⁴ 65 Pa.C.S. § 709.

⁶⁵ 65 Pa.C.S. § 705.

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- Written minutes must be kept, which include the “substance of all official actions and a record by individual members of the roll call votes taken.”⁶⁶

We found that the Investment Board complied with most of the Sunshine Act provisions, as discussed in the paragraphs that follow.

Public notice. Investment Board meetings were announced with meeting notices published in *The Patriot-News*, Harrisburg, and via postings on the Department of Community and Economic Development’s public bulletin board located in the Commonwealth Keystone Building in Harrisburg. Regarding the latter type of posting, we verified that the November 17, 2008, meeting notice was posted as stated in the Commonwealth Keystone Building. Investment Board staff also noted that copies of meeting announcements were routinely provided to the General Assembly.

Publicly cast votes. At the November 17, 2008, Investment Board meeting that we attended, we observed that Investment Board members publicly cast their votes as required.

Meeting minutes. We noted previously that Investment Board meeting minutes, although abbreviated, were developed from meeting transcripts. While the transcripts were not retained and the summary of minutes was not available online, the Investment Board did make the abbreviated minutes available to the public upon request.

In addition to the Sunshine Act requiring written meeting minutes, the Tobacco Settlement Act states that “the board shall keep a record of its proceedings.”⁶⁷ When audit staff attended the November 17, 2008, annual meeting of the Investment Board, we noted that a transcriber was recording

⁶⁶ 65 Pa.C.S. § 706.

⁶⁷ 35 P.S. § 5701.304(d).

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the meeting. The Investment Board pays a fee to a transcriber for each board meeting.

However, as noted previously, when we asked for copies of the meeting transcripts, we learned that the transcripts were destroyed after the meeting minutes were prepared. According to Investment Board staff, the verbatim transcripts were destroyed because they were no longer needed by the board, a position that the board should reconsider based on our observation that the minutes provided an insufficient summary of the meetings.

Recommendations

8. The Investment Board should retain all meeting transcripts.
9. The Investment Board should record more detailed meeting minutes that accurately and thoroughly explain the details of the board meetings as required by the Sunshine Act.⁶⁸

⁶⁸ 65 Pa.C.S. § 706.

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**Finding Two
Board
Operations**

The Tobacco Settlement Investment Board did not have a policy and procedure manual for the administrative operations carried out by staff but generally adhered to Commonwealth requirements in the areas we reviewed, including certain procurements, budgetary submissions, and expenditure payments.

The Investment Board staff is responsible for carrying out the daily administrative operations for the Investment Board. Such activities include procurement, budgeting, and payment of expenses. However, the Investment Board did not have a formal policy and procedure manual to document how these administrative operations should be carried out, primarily by staff.

In this section of the report, we present the details that led to the finding above. In particular, we discuss the following:

1. The Investment Board did not have a policy and procedure manual for staff.
2. When hiring its investment consulting firms, of which there were two, the Investment Board said the competitive bidding process was followed and could document the process for the second hire.
3. When procuring legal services the investment board produced documentation showing it received approvals for those services, but documentation related to emergency procurements was unclear. For due diligence services, the board had no documentation because those services were procured by another agency prior to our audit period.
4. The Investment Board approved and submitted budgets annually as required, and paid its expenses from the Health Endowment Account as it should have done.

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The methodology we used to develop this finding and the related discussion points includes our completion of the following tasks:

- Obtained Investment Board budgets for the fiscal years ended June 30, 2006, 2007, and 2008.
- Interviewed Investment Board staff.
- Interviewed DCED legal staff that worked on behalf of the Investment Board.
- Interviewed Treasury Department staff.
- Interviewed Comptroller's Office staff.
- Obtained spreadsheets from the Comptroller on payments made by the Investment Board.
- Reviewed and analyzed consultant contracts.
- Obtained, read, and analyzed pertinent sections of the Commonwealth Procurement Code.
- Reviewed the Tobacco Settlement Act.

Our discussion in the pages that follow shows, in accordance with government auditing standards, how our audit work provides reasonable assurance that evidence is sufficient and appropriate to support our findings and to draw the conclusion that, even though the Investment Board generally complied with the Commonwealth requirements in the areas we reviewed, it should have a policy and procedure manual as a good management and operational tool.

**Discussion
point 1**

The Investment Board did not have a policy and procedure manual for staff.

While the Investment Board has developed a set of bylaws that guides its actions, these bylaws⁶⁹ do not address the policies and procedures of the Investment Board staff, with one exception. The bylaws state the Investment Board may appoint an executive director and other employees, and that the duties of the executive director shall "have general supervision and

⁶⁹ The Board calls its bylaws "policies and procedures."

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direction of the business affairs of the board.” No further or more specific information was provided about the Investment Board staff in these bylaws.

In the absence of staff policies in the bylaws, we requested a copy of the Investment Board’s employee procedures manual. The Investment Board staff stated that no employee procedures manual existed, explaining that a procedures manual had not been created because the staff “has developed processes over time.”⁷⁰

While we did determine that the Board follows various certain policies and procedures, many of them written, we found that the lack of a consolidated but comprehensive policy and procedure manual to be a shortcoming. This type of manual is an important tool for any organization, no matter the size, but is especially critical for an organization responsible for investing billions of dollars used for state programs.

A comprehensive document that compiles operational procedures in one place and ties those procedures to the applicable policies is more than just a paper exercise. Overall, the existence of a well-prepared and organized manual represents that the Board is managed and operated professionally according to institutional standards.

Whether discussing general operations, human resource issues, or fiscal practices, a manual for the Investment Board’s staff would serve as a reference tool, preserve institutional knowledge, provide a means for evaluating compliance, and standardize operations as follows:

- It would provide employees with a clear and common understanding of the Investment Board’s mission, organizational objectives, expectations in regard to performance and conduct, and benefits.

⁷⁰ October 30, 2008, meeting with board staff and the Department of Community and Economic Development’s chief counsel.

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- It would document in one place the purpose statement for each policy and procedure area, along with the policies and procedures themselves, further information, references, and notes on related policies.
- It would assist in ensuring consistent operations in the event of staff turnover, thereby minimizing disruption and loss of organizational knowledge.
- It would assist in the training of new staff, as it could have done in July 2008 when an additional administrative officer was hired.
- It would function as a monitoring tool for the Investment Board in evaluating the performance and effectiveness of staff.

More specifically, critical items that should be included in the policies and procedures manual include—but are not limited to—the following:

- Mission statement, core values, vision, and principles, in addition to the specific purpose statements for each policy and procedure area
- Investment philosophy and policies
- Job duties, expectations, and responsibilities of each staff member
- Conflict of interest policy and procedures applicable to both Board and staff
- Procurement procedures
- Expense procedures

Recommendation

10. The Investment Board should compile a comprehensive policy and procedure manual for staff to follow, and to serve as public testament that the Board is operated professionally and according to institutional standards.

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**Discussion
point 2**

When hiring its investment consulting firms, of which there were two, the Investment Board said a competitive bidding process was followed and could document the process for the second hire.

The Investment Board is subject to the provisions of the Commonwealth Procurement Code,⁷¹ which mandates the actions that government entities must follow when entering into contracts for supplies, services, or construction.

The procurement code states that all Commonwealth agency contracts must be awarded by competitive sealed bidding, unless otherwise provided by certain exceptions. One exception to the competitive sealed bidding process is the awarding of a contract through the sole source process,⁷² which allows for the awarding of a contract without competition as long as one of ten criteria outlined in the procurement code is met.

In this discussion point, we address the hiring of the Board's investment consultants, of which there were two—one hired in November 2001 before our audit period began and the other hired in September 2008 to replace the first firm, but after our primary audit period ended.

In both cases, the Board said that competitive bidding requirements had been followed; in the second case, because the second firm was under consideration before our audit period ended, Investment Board staff could produce documentation to show that certain verifiable steps were followed. In the first case, Investment Board staff could produce only limited documentation to show that competitive bidding procedures had occurred. The Board explained that it

⁷¹ 62 P.S. § 101 *et seq.* Throughout this report, the Commonwealth Procurement Code will be referred to as the procurement code.

⁷² 62 Pa.C.S. § 515.

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had only the limited documentation because the hiring had occurred three years before our audit period and was handled by another state agency before the Department of Community and Economic Development was designated to assist the Board in its operations. Investment Board staff said that, despite its repeated requests for documentation from the other agency, no documentation was provided. Our own request to the other agency also resulted in that agency's inability to provide documentation.

First Investment Consultant. When the Governor's Office of Administration was providing administrative assistance to the Investment Board prior to the Department of Community and Economic Development's involvement, the Board entered into a contract with Wilshire Associates Incorporated (which we will refer to as the First Investment Consultant), a corporation headquartered in California but with a Pennsylvania office in Pittsburgh, on November 30, 2001. The firm was also under contract with the Pennsylvania State Employees' Retirement System.

The contract with this First Investment Consultant was extended several times, as we will discuss, through February 28, 2009, for investment consulting and performance measurement; account recommendations, including investment objectives, policies, asset allocation, and fund managers; one-year, three-year, and ten-year investment plans; monthly, quarterly, and annual reporting; comparative analyses; benchmarking; accounting for investments and cash flows; research; information on market conditions; regular meetings to report on investment matters; and assistance in selecting fund managers for the Health Venture Account.

The Investment Board's contract with the First Investment Consultant originally covered a five-year term, through November 30, 2006, with an annual contract fee of \$150,000 payable quarterly. On November 14, 2006, two weeks prior to the end of that original contract, the Investment Board sent an extension letter to the First Investment Consultant saying that

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the Board “is currently processing an RFP [Request for Proposal] for a new contract with a consultant to provide general investment consulting services to the Board for the next five years.” However, the letter also noted that the next consultant would not be under contract before the November 30, 2006, expiration date, and that the Board would extend the expiration date to February 28, 2007. The First Investment Consultant agreed to this extension.

Transition to Second Investment Consultant. The Investment Board continued the services of the First Investment Consultant at the same \$150,000 rate through further extensions ending August 31, 2007, and August 31, 2008. In the meantime, the Board selected another investment consultant (or Second Investment Consultant) whose contract would not become effective until at least November 2008. Therefore, the Board requested and received Commonwealth authorization for the Second Investment Consultant to begin work under an emergency purchase request while the contract was being finalized. Soon thereafter, the Board also extended the contract of the First Investment Consultant for six months so it could complete and submit its reporting for the fiscal year that had just ended, thereby ensuring a smooth transition from one consultant to another.

In determining whether competitive bidding was followed for the First Investment Consultant, we found language in the original contract indicating that competitive bidding had occurred. Aside from that support, the Board had no further documentation because the hiring had been done by the former agency.

With regard to the Second Investment Consultant—the current one that provides essentially the same services as those we listed for the First Investment Consultant, *plus* due diligence services—the Board produced far better documentation to show that this Second Investment Consultant was hired through competitive bidding. Specifically, the Board produced documentation relating to the request for proposal and the

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advertising for bids, in addition to a list of other bidders, the finalized contract that references the bidding process, and various pieces of correspondence to satisfy us that competitive bidding had occurred. Please note, however, that we did not audit the actual bidding and selection process itself.

The finalized contract for the Second Investment Consultant had an effective date of November 18, 2008, and was made between the Board and Callan Associates, headquartered in California with a regional office in New Jersey. The contracted fees total \$1,071,000 for the contract term, which expires on December 31, 2012, including the initial period when services were obtained through the emergency purchase request.

Recommendation

11. Going forward, the Board should ensure that it retains, and, if necessary, seeks or continues to seek the historical information and documentation concerning the procurement process of entities under contract.

**Discussion
point 3**

When procuring legal services, the Investment Board produced documentation showing it received approvals for those services, but documentation related to emergency procurements was unclear. For due diligence services, the Board had no documentation because those services were procured by another agency prior to our audit period.

As stated in the preceding discussion point, procurement of services for the Commonwealth can be obtained through the sole source process,⁷³ meaning that contracts can be awarded without competitive bidding as long as at least one criterion is

⁷³ 62 Pa.C.S. § 515.

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met out of ten that are listed in the Commonwealth procurement code.

Legal Services. When contracting for legal services, the Investment Board was able to show us that it used the sole source process for the two law firms (see First Law Firm and Third Law Firm in this section) for which there were fully executed contracts, based on meeting the following criterion:

- The services are to be provided by attorneys or litigation consultants selected by the Office of General Counsel, the Office of Attorney General, the Department of the Auditor General, or the Treasury Department.⁷⁴

First Law Firm - The Investment Board entered into a contract on January 1, 2006, with this First Law Firm to represent the Investment Board in “matters relating to structuring and documenting investment transactions for the Investment Board.”

The contract stated the following:

The law firm shall consult with and keep the Office of General Counsel, and the [Investment Board] fully informed as to the progress of all matters covered by this contract. The law firm shall consult and cooperate with, and shall be responsible directly to the General Counsel on all matters of strategy and tactics. The duty of the law firm shall be to advise, counsel, and recommend actions to the [Investment Board] through the General Counsel and the other officials designated by the Office of the General Counsel and to carry out to the best of its ability their directions.

⁷⁴ 62 Pa.C.S. § 515(5).

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The contract's original expiration date was June 30, 2007, and was extended an additional year, until June 30, 2008. However, on February 29, 2008, four months prior to the new expiration date, the Office of General Counsel and the Department of Community and Economic Development abruptly terminated this contract, stating in a letter to the firm that "the Department has determined that termination is in the best interest of the Commonwealth." In response to our questions, DCED counsel could provide no specific information on why this contract was terminated.

Second Law Firm – On February 27, 2008, two days prior to the termination of the contract with the First Law Firm, the Department of General Services approved an emergency request from the Investment Board to procure legal services with another law firm, or Second Law Firm. Although the Board intended ultimately to procure the services through the sole source/legal services exception to the competitive bidding requirements, it sought emergency procurement⁷⁵ approval, apparently in order to allow the Second Law Firm to provide services for 90 days while the sole source documentation was being finalized. However, the Investment Board elected not to proceed to a fully executed contract with this Second Law Firm. Regardless, it is not clear what "emergency" necessitated the firm to start work on an expedited basis. The documentation provided by the Board merely echoes the statutory criterion that "[c]ircumstances outside the control of the agency create an urgency of need, which does not permit the delay involved in using more formal competitive methods," without giving any hint as to the nature of those "circumstances."

Third Law Firm – The effective date listed on the contract for the Third Law Firm (the firm under contract with the Investment Board as of the date of this report) is January 7, 2009. The contract designates the Governor's Office of General Counsel as the entity that "supervises, coordinates, and

⁷⁵ See 62 Pa.C.S. § 516.

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administers the legal services for each Executive Agency.” Therefore, the Investment Board’s hiring of this Third Law Firm meets the following sole source procurement criterion previously noted:

- The services are to be provided by attorneys or litigation consultants selected by the Office of General Counsel, the Office of Attorney General, the Department of the Auditor General, or the Treasury Department.⁷⁶

We note for clarification purposes that the original procurement of this Third Law Firm’s services actually took place months earlier, on August 15, 2008, based on another approval by the Department of General Services for emergency procurement of legal services for 90 days, after which there was one extension. The contract of January 7, 2009, makes reference to and incorporates the emergency procurement arrangement, indicating that the law firm could provide services between the date of the emergency approval and the issuance of the fully executed contract, similar to the original intention with regard to the Second Law Firm. The “emergency” cited in the documentation was an unnamed “transaction which must be handled immediately.”

Due Diligence Service Provider. “Due diligence” includes research, analysis, and investigation of a company and its debts, pending and potential lawsuits, leases, agreements, contracts and other obligations prior to entering into a business transaction with the company.

When contracting for due diligence services, the Investment Board said it was unable to speak to the process that was followed prior to the involvement of the Department of Community and Economic Development, and prior to the start of our audit period. Therefore, although current DCED staff,

⁷⁶ 62 Pa.C.S. § 515(5).

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Investment Board staff, and other parties we contacted said they *believed* sole source procedures were followed, they could not provide any corroborating documentation despite the fact that procurement records are to be retained at least three years from the date of final payment under the contract.⁷⁷ We note that the due diligence contractor in question is no longer providing these services, which are now provided by the Second Investment Consultant as indicated in the previous discussion point. Nevertheless, the Investment Board should have ensured it obtained all procurement documentation even though another agency procured the services in question.

Recommendation

12. The Investment Board should provide a complete explanation in its contract files of the nature of any “emergency” that the Board cites as the basis for not complying with the competitive bidding requirements of the Commonwealth procurement code.

Note: Recommendation 11 from the previous discussion point applies here as well: Going forward, the Board should ensure that it retains and, if necessary, seeks or continues to seek the historical information and documentation concerning the procurement process of entities under contract.

**Discussion
point 4**

The Investment Board approved and submitted budgets annually as required, and it paid its expenses from the Health Endowment Account as it should have done.

Budgets. The Investment Board’s budget was approved by Board members each year. Included in the budget were expenditures for staff salaries and benefits, professional

⁷⁷ See 62 Pa.C.S. §§ 563-564.

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services fees, insurance costs, and comptroller support costs. This approved budget was then incorporated into the annual budget of the Department of Community and Economic Development, and subsequently submitted to the Governor's Office of the Budget as required.

For the past three fiscal years, the budget for the Investment Board has been as follows:

- \$659,000 for fiscal year 2006-07
- \$827,000 for fiscal year 2007-08
- \$903,000 for fiscal year 2008-09

Board and Staff Expenses. Investment Board and staff expenses are paid with monies from a cash management account within the Tobacco Settlement Fund as the expenses are incurred. At the end of each fiscal year, this account is reimbursed with money from the Health Endowment Account. This payment practice complies with the requirements of the Tobacco Settlement Act, which states that all Investment Board expenses, including professional personnel expenses, are to be paid from the Health Endowment Account.⁷⁸

The Investment Board has established three levels of signatory authority before its expenses are paid from the Health Endowment Account. All payments must contain the signature of (1) the Investment Board executive director, (2) the Secretary or Assistant Secretary of the Board, and (3) a Treasury Department official.

We found that the Investment Board did not submit invoices to the Treasury Department when requesting payment for those invoices. In response, the Investment Board staff said it had all invoices, produced samples for us, explained that Treasury had neither asked nor required the Board to submit the invoices, and—as a result of this report—has scheduled a meeting with Treasury to discuss and resolve this issue.

⁷⁸ 35 P.S. § 5701.304(c).

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Recommendation

13. The Investment Board should ensure that its staff follows through in meeting with officials of the state Treasury Department to determine the precise requirements when submitting payment requests.

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**Finding Three
Investment
Guidelines
and
Policies**

The Tobacco Settlement Investment Board lacked a consolidated policy document of investment guidelines and its investment manager monitoring process. Nevertheless, the Board participated in the process by which the investment consultant selected investment managers for the Board to hire; the Board also complied with investment requirements such as investing mostly in Pennsylvania companies and in monitoring of the investment earnings of the Life Sciences Greenhouse program.

The Investment Board has a fiduciary⁷⁹ responsibility to invest, reinvest, and manage the billions of dollars that are used to fund Commonwealth health, aging, insurance, and welfare programs. Accordingly, a consolidated investment policy document is critical to the Investment Board because it provides written testament in assisting the Board to fulfill its fiduciary responsibility, and in assisting Investment Board staff and the Board's investment contractors in making daily decisions about investment matters. An investment policy document also provides a further basis for evaluating the performance of individual investment managers and the overall success in meeting investment objectives.

In this section of the report, we present the details that led to the finding above. In particular, we discuss the following:

1. The Investment Board lacked a consolidated investment policy for the Tobacco Settlement Fund and its related accounts.
2. The Investment Board staff participated in the process by which the investment consultant selected investment managers for the Health Endowment Account.

⁷⁹ 35 P.S. § 5701.305(b).

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3. The Investment Board did not formalize an investment manager monitoring process and, as a result, relied on the investment consultant to monitor the performance of investment managers.
4. The Investment Board complied with the requirement that at least 70 percent of Health Venture Account investments were made in Pennsylvania companies. In addition, Health Venture Account funds were invested in companies employing Pennsylvania workers.
5. Investment Board staff monitored the investment earnings of the Life Sciences Greenhouse program.

The methodology we used to develop this finding and the related discussion points includes our completion of the following tasks:

- Obtained and reviewed applicable laws, bylaws, policies and procedures.
- Obtained and reviewed background information on the Health Endowment Account, Health Venture Investment Account, and Life Sciences Greenhouses.
- Conducted interviews with the executive director and other Investment Board staff.
- Obtained and reviewed copies of the Investment Board's contracts with its investment consultant, investment managers, and other professionals for legal and due diligence services.
- Obtained and reviewed copies of investment policies from PSERS and the Pennsylvania Treasury Department to obtain an understanding of criteria for investment policies.
- Obtained and reviewed the Investment Board's annual reports for fiscal years ended June 30, 2006, 2007, and 2008.
- Obtained and reviewed the Tobacco Settlement Fund's audited financial statements for fiscal years ended June 30, 2006, 2007, and 2008.

Our discussion in the pages that follow shows, in accordance with government auditing standards, how our audit work

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provides reasonable assurance that evidence is sufficient and appropriate to support our finding and to draw the conclusion that the Tobacco Settlement Investment Board complied with requirements in various aspects of our review but could do more in regard to its investment practices overall.

**Discussion
point 1**

The Investment Board lacked a consolidated investment policy for the Tobacco Settlement Fund and its related accounts.

The Investment Board did not develop an investment policy document to define its guidelines for investing tobacco settlement monies in the Tobacco Settlement Fund, the Health Endowment Account, and the Health Venture Account, which have a combined net worth of over \$1 billion. The Investment Board staff explained that the Board does indeed have investment guidelines but has not compiled them into one policy document. Instead, staff said that the Board places investment guidelines into each of its contracts with investment managers and its investment consultant. In addition, investment decisions are discussed at Investment Board meetings, recorded in board meeting minutes, and discussed in the quarterly report of the investment consultant.

Investment guidelines as part of contracts. Each account within the Tobacco Settlement Fund, the Health Venture Account, and the Health Endowment Account is the responsibility of an investment manager on contract with the Investment Board. Each contract contains the investment guidelines and parameters that the investment manager must adhere to in investing account monies.

We obtained four investment manager contracts and noted that each one contained an investment policy statement. The statements outlined how the manager should invest account monies, the level of risk that could be taken, investment timeframes, and prohibited investment activities.

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Although the investment statements in these contracts appear to provide direction and goals on an individual account basis, the statements do not provide information on the Investment Board's overall investment strategy or policy.

Investment guidelines as part of Investment Board meetings and meeting minutes. Investment Board staff stated that investment decisions are discussed at the Board meetings and that members then vote on investment policies. Such discussions and votes are recorded in the Investment Board meeting minutes.

We obtained and reviewed the meeting minutes for all Investment Board meetings held between July 1, 2005, through June 30, 2008, and we confirmed that—based on those official records of meetings—the Investment Board discussed investment policies, considered recommendations from the investment consultant, and voted on investment resolutions. We also confirmed that the Investment Board discussed investment strategies, benchmarks, goals, and objectives at these Board meetings.

The Investment Board staff said it considered the Board meeting minutes to be a reliable source document for investment policy and reiterated that the minutes are official records of meetings. However, as we discussed in Finding One, we found that the Investment Board meeting minutes were too abbreviated and therefore inadequate, especially considering that the complete meeting transcripts had been prepared but then discarded when the abbreviated minutes were approved by the Board. Therefore, we cannot consider the meeting minutes to be a thorough representation of the Board meeting discussions because we could not compare the abbreviated minutes to the full meeting transcript.

Investment guidelines as part of annual report. Investment Board staff also stated that the Board's investment policy for the Tobacco Settlement Fund and the Health Endowment Account is contained in the annual reports prepared by the investment consultant on contract with the Investment Board.

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The Investment Board considers these various reports to serve adequately as an investment policy.

Our review of these reports dated June 30, 2006, 2007, and 2008, showed that the reports include tables listing the investment goals for the Tobacco Settlement Fund and the Health Endowment Account and comparing those goals to actual investment performance. However, as we discussed in Finding One, the annual reports are not clear, concise, or reader-friendly, and the disjointed presentation makes it difficult for readers to understand the investment policies, much less locate them.

By way of contrast, we found that the Public School Employees' Retirement System, the State Employees' Retirement System, and the state Treasury Department all have actual investment policy documents covering all facets of their assigned responsibilities for fund oversight, investment management, and asset allocations.⁸⁰ Like the Investment Board, each of these agencies acts in a fiduciary capacity over the investment of billions of dollars that benefit Commonwealth citizens. Furthermore, these agencies make their investment policy documents available for public review by placing them on their respective Web sites.

Recommendation

14. The Investment Board should develop a comprehensive investment policy document (and post it on its Web site) that outlines its investment guidelines as well as its assigned responsibilities for fund and account oversight, investment management, and asset allocations.

⁸⁰ We are not making an assessment of the quality of the actual policy documents of these entities.

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**Discussion
point 2**

The Investment Board staff monitored and participated in the process by which the investment consultant selected investment managers for the Health Endowment Account.

As discussed earlier in this report, the Investment Board hired an investment consultant for investment advice and fund management services. According to the contract between the Investment Board and the consultant during our audit period, it was a duty of the consultant to recommend investment managers for the Health Endowment Account which, as we explained early in this report, was originally intended to serve as a long-term investment.

As of June 30, 2008, the Investment Board had more than 21 investment managers for the Health Endowment Account investments. The contract periods and fees vary by contract, but the duties and responsibilities expected from each investment manager are essentially the same. Our review of a sample of the investment manager contracts revealed the following responsibilities and duties of the investment managers:

- Contractors act as investment portfolio managers.
- Contractors have sole discretion to make and carry out decisions with respect to the acquisition, the holding, and the disposition of securities or any other assets of the portfolio.
- Contractors have full power and authority to invest and reinvest the assets of the account in investments of any kind in accordance with the guidelines.
- Contractors provide monthly and/or quarterly reports to the Investment Board on the receipts, disbursements, and value of the account.
- Contractors are prohibited from investing in tobacco.

The Investment Board relied on its investment consultant for the selection of these investment managers, but Board staff

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explained that the executive director played an active role in this process. Based on our interviews and discussions, the entire process as it occurred is explained in the narrative that follows:

When the Investment Board was interested in hiring a new investment manager for the Health Endowment Account, it asked the investment consultant to begin a search. The investment consultant maintained a database of investment managers and, in reviewing this database, developed a short list of prospects.

The Investment Board required each investment manager on this short list to undergo a due diligence background investigation as directed by the investment consultant.

In addition to undergoing due diligence, each applicant was required to make a presentation to the Investment Board. Based on the applicant's presentation to the Investment Board and the findings from the due diligence investigation, the investment consultant recommended the top three candidates to the Board. The Board then voted on the selection of a candidate to become the investment manager.

The role of the Investment Board's executive director was to function as an adjunct to the investment consultant's team. In so doing, the executive director participated in the review of the consultant's database, interviewed manager applicants, and worked with the investment consultant to develop the short list of candidates for presentation to the Board for its vote on the ultimate selection.

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**Discussion
point 3**

The Investment Board did not formalize an investment manager monitoring process and, as a result, relied on the investment consultant to monitor the performance of investment managers.

Although the Investment Board did not develop its own written procedures with regard to investment monitoring activities and responsibilities, the Investment Board staff said that investment managers underwent three levels of oversight to ensure compliance with the investment guidelines contained in the contracts.

According to our interviews, discussions, and documentation, the three-level review works as follows:

For the first-level review, the Investment Board expects the investment manager to self-monitor by conducting periodic reviews of its investments to ensure it is compliant with the terms of the contract. The second-level review is conducted by the investment consultant, whose team is expected to conduct periodic reviews of the investment managers' asset portfolios to ensure compliance with the contractual investment guidelines. The third-level review is conducted by the Investment Board's executive director who, according to interviews, reviews investment transactions on a daily, weekly, and monthly basis to ensure that the investment managers are adhering to the terms of their contracts.

Notwithstanding these three levels of review, the Investment Board delegated a significant amount of investment manager oversight responsibilities to the investment consultant, and the Investment Board staff noted that it "relies heavily on the investment consultant to monitor investment activity." The investment consultant is expected to report to the Investment Board the findings of its monitoring activities.

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We obtained copies of reports prepared by the investment consultant for submission to the Board. In determining the level of investment manager monitoring information provided to the Investment Board, we found the following:

- On a monthly basis, the investment consultant provided an “investment performance analysis” report to the Investment Board. This report presented the rate of return on investments for each investment manager of the Health Endowment Account and the Tobacco Settlement Fund (but not the Health Venture Account) and compared this rate of return to the benchmark assigned to each manager.⁸¹ With the hiring of a new investment consultant, these monthly reports will begin to include the same information for the investment managers of the Health Venture Account.
- On a quarterly basis, the investment consultant provided the same type of information to the Investment Board as it did on a monthly basis, but the information was supplemented with several pages of analysis on the investment performance of each investment manager for the Tobacco Settlement Fund and the Health Endowment Account.
- On an annual basis, the Investment Board received the investment consultant’s annual report (as discussed in Finding One). Included in this report was the same type of information presented on a monthly and quarterly basis, along with a report on “manager objectives review.” This report presented the investment goal, the investment philosophy, the investment objectives in measurable terms, and compliance with those objectives for each investment manager of the Health Endowment Account and the Tobacco Settlement Fund.

⁸¹ Examples of benchmarks include the Standard & Poor’s 500 for some investment managers and the 91-day Treasury bill for other investment managers.

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-
- The investment consultant also provided the Investment Board with analytical reports of investment management fees, benchmark analyses, portfolio reviews, and investment rebalancing recommendations.

Recommendation

15. The Investment Board should develop investment monitoring procedures and clearly delineate the responsibilities to be undertaken by the investment managers, the investment consultant, and the Investment Board staff.

**Discussion
point 4**

The Investment Board complied with the requirement that at least 70 percent of Health Venture Account investments were made in Pennsylvania companies. In addition, Health Venture Account funds were invested in companies employing Pennsylvania workers.

With regard to the Health Venture Account, the Tobacco Settlement Act states the following:

The board may invest in one or more limited partnerships or comparable investment entities provided that the investment guidelines and strategies of each investment entity require that at least 70% of the investments will be made in companies located primarily in Pennsylvania or in companies willing to relocate significant business operations to Pennsylvania.⁸²

In our review of the contracts between the Investment Board and the Health Venture Account investment managers, we found that this requirement was included as a provision in the contracts.

⁸² 35 P.S. § 5701.305(f).

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On the other hand, the Investment Board’s annual reports did not present the investment activities of the four investment managers in a clear enough manner that we were able to determine from reading these reports whether this contract provision was actually met. While the annual reports included information on investments in Pennsylvania companies, the information did not quantify these investments as a percentage. Therefore, we could not rely on the reports and instead asked the Investment Board staff to disclose the percentage of Health Venture Account investments made in Pennsylvania companies.

In response to our request, the Investment Board staff provided the information that we present in the table below:⁸³

Percentage of Health Venture Account investments in Pennsylvania companies			
	FY 2005-06	FY 2006-07	FY 2007-08
Health Venture Account investment manager:			
Quaker BioVentures	91%	92%	91%
PA Early Stage/Novitas Capital	74%	80%	83%
Birchmere Ventures III	100%	100%	100%
Commerce Health Ventures	75%	94%	83%
Account Total	86%	91%	89%

The four Health Venture Account investment managers annually provide the number of jobs created to the Investment Board staff for inclusion in the Investment Board’s annual report. This report, once reviewed by the Investment Board, is then distributed to the General Assembly in accordance with Tobacco Settlement Act requirements.

Using these annual reports as our source document, we calculated that 3,561 jobs were maintained or created as a

⁸³ Please note that we did not audit how much of the required capital to be contributed by general partners was invested in Pennsylvania companies.

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result of venture capital investments as of June 30, 2008. This number represents an increase of 152 jobs over the 3,409 reported the previous year as of June 30, 2007, and an increase of 543 jobs over the 3,018 reported as of June 30, 2006.

Overall, then, the annual reports show an increase of 543 jobs created or maintained as a result of venture capital investments. As noted, however, we calculated these numbers based on the Board's annual reports, meaning that the numbers themselves are not audited.

Recommendations

16. The Investment Board should ensure that its annual reports quantify the investments in Pennsylvania companies as a percentage.
17. The Investment Board should require that its investment managers provide audit evidence or other acceptable verification that the number of jobs actually created is equal to the number reported, in at least a sample of cases.

**Discussion
point 5**

Investment Board staff monitored the investment earnings of the Life Sciences Greenhouse program.

While the Life Sciences Greenhouse program was created in accordance with provisions of the Tobacco Settlement Act and was initially funded with a one-time \$100 million appropriation from the Tobacco Settlement Fund, this program is the responsibility of the Department of Community and Economic Development, not the Investment Board. Nevertheless, the Tobacco Settlement Act specifies that the Health Endowment Account is a beneficiary of any earnings accrued from the intellectual property or products which were developed as a

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result of research conducted through the Life Sciences Greenhouse program once certain conditions are met.⁸⁴

To determine if any such earnings are due to the Health Endowment Account, according to our interviews with Investment Board staff, the Investment Board's executive director reviews—on behalf of the Department of Community and Economic Development—the financial statements of the Life Sciences Greenhouse program's investments. These financial statements are prepared by the Department of Community and Economic Development's independent contractor. In addition, an accounting firm certifies the greenhouse investments for the Investment Board's executive director. According to the information we obtained from our interviews, no earnings were due to the Health Endowment Account from the Life Sciences Greenhouse program as of December 2008, and thus no transfers were made.

⁸⁴ 35 P.S. § 5701.1703(g)(3).

Appendix A

*Objectives, Scope,
and Methodology*

Tobacco Settlement Investment Board

*Pennsylvania Department of the Auditor General
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Appendix A
**Objectives,
Scope, and
Methodology**

The Department of the Auditor General conducted this special performance audit in order to provide an independent assessment of the Investment Board's administration of the Tobacco Settlement Fund. Furthermore, we conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Objectives

Our special performance audit of the Tobacco Settlement Investment Board was conducted following a request by leadership of the House Appropriations Committee. Our overall objective for this audit was to evaluate the Investment Board's oversight of the Tobacco Settlement Fund and, in summary, comprised the following questions:

1. Did the Investment Board comply with its administrative requirements?
2. How was the Investment Board staffed, and what are its employment practices and policies?
3. Did the Investment Board establish investment guidelines, and to what extent does the board monitor such guidelines?
4. Did the Investment Board act in a fiduciary manner, and how were potential conflicts of interest avoided?
5. How were monies in the Health Venture Account, the Health Endowment Account, and the Life Sciences Greenhouse program expended?

Appendix A

Tobacco Settlement Investment Board

*Objectives, Scope,
and Methodology*

Pennsylvania Department of the Auditor General

Jack Wagner, Auditor General

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Scope

This audit report presents information for the period of July 1, 2005, through June 30, 2008, with information through February 23, 2009, as available.

This audit was a special performance audit of the Investment Board; it was not an audit of the financial statements of the Tobacco Settlement Fund. Our Bureau of Federal Audits has audited the Tobacco Settlement Fund every year since the Fund's inception as part of the Comprehensive Annual Financial Report (CAFR). In addition, the Bureau of Federal Audits conducted a separate financial statement audit of the Tobacco Settlement Fund for the fiscal year ended June 30, 2008, and issued that report on December 23, 2008. For the fiscal year ended June 30, 2007, an outside auditing firm (with whom the Board contracted) conducted a financial statement audit of the Fund.

Methodology

To address our audit objectives, we performed the following procedures:

- Obtained and reviewed applicable laws, regulations, bylaws, executive orders, management directives, policies, procedures, annual budgets, audited financial statements, status of appropriation reports, Investment Board meeting minutes, and Investment Board annual reports for the fiscal years ended June 30, 2006, 2007, and 2008.
- Conducted interviews with the Investment Board's executive director and staff, and officials from the Department of Community and Economic Development, the Treasury Department, the State Ethics Commission, the Office of Administration, and the Comptroller for Labor, Education, and Community Services.
- Conducted telephone interviews with two Investment Board members regarding their Tobacco Settlement Fund oversight responsibilities.

Appendix A

*Objectives, Scope,
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February 2009*

-
- Obtained and reviewed the Governor's Code of Conduct statements of financial interest and the State Ethics Commission statements of financial interest for Investment Board members and Investment Board staff for all three years of our audit period.
 - Obtained samples of Investment Board service purchase contracts for the following services: investment consulting, investment management, legal, and due diligence services.
 - Reviewed the Investment Board's procedures for obtaining service contractors to determine compliance with Commonwealth procurement requirements.
 - Reviewed the composition, job duties and responsibilities, compensation, and practices of the Investment Board staff.

By December 31, 2008, we completed much of our field work, including follow-up questions and discussions with Investment Board staff. After that date, we continued our audit work through February 20, 2009, including questions and further information requests. We provided a draft report to Investment Board staff on February 20, 2009, and we received a written response signed by the Board's chairman on February 23, 2009. The written response is included on page 73 of this report.

Findings and Recommendations

We developed three findings and their resulting conclusions, all of which we break down into 15 discussion points for presentation. We also present 17 recommendations to address the issues we identified, and we will follow up within the next 12 to 24 months to determine the status of our findings and recommendations.

Our expectation is that our findings and recommendations will improve the performance of the Investment Board, in particular its transparency and public accountability, by providing a framework for corrective action as necessary.

Tobacco Settlement Investment Board

*Questions and
Answers*

*Pennsylvania Department of the Auditor General
Jack Wagner, Auditor General
February 2009*

Appendix B

**Questions and
answers about
the Investment
Board**

The following is information that we obtained during the course of our audit. Although some of the answers may contain unaudited information because certain questions did not fall directly within our audit objectives, the information is helpful to understand how the Investment Board operates.

Q. How does the Investment Board ensure that the investment decisions regarding the Tobacco Settlement Fund and the Health Endowment Account are in compliance with the standard of prudence established by Section 305(a) of the Act?

A. Under Section 305(a) of the Tobacco Settlement Act, “the board shall have exclusive control and authority to manage, invest, and reinvest money in the [Tobacco Settlement] fund and the Health [Endowment] Account..., subject, however, to the exercise of that degree of judgment, skill and care under the circumstances then prevailing that persons of prudence, discretion and intelligence, who are familiar with investment matters, exercise in the management of their own affairs....”⁸⁵

The Investment Board incorporates prudence language into its agreements with its investment managers. We reviewed a sample of these agreements and noted that the Investment Board requires the managers to notify the board of “any material adverse development in the ability of the [investment manager] to manage the portfolio either in accordance with the standards of a prudent investment manager or within the context of this statement of investment policy.”

The Investment Board staff informed us that, with the assistance of the investment consultant, it monitors the

⁸⁵ 35 P.S. § 5701.305(a).

Appendix B

Questions and
Answers

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investment managers' compliance with these agreements including the requirements regarding prudence.

Q. How does the Investment Board ensure that the requirements as outlined in the Tobacco Settlement Act for venture capital investments are met?

A. The Tobacco Settlement Act⁸⁶ lists six requirements for venture capital investments, which are summarized below:

- Each general partner must contribute certain percentages of capital.
- The partnership must provide a five percent rate of return to all limited partners.
- The partnership must operate under the “prudent expert standard of care.”
- The Investment Board must have a seat on certain limited partner committees.
- The Investment Board must be reimbursed for expenses for attending these committee meetings and partnership annual meetings.
- The partnership must give the Investment Board copies of audited financial statements.

During the audit period, the Investment Board had four limited partnership agreements with four venture capital investment managers to manage and invest the monies in the Health Venture Account. According to Investment Board staff, all of the above requirements were contained in each limited partnership agreement.

Specifically, our review of the agreements with the four investment managers revealed that two of the four agreements contained language that required the general partner to agree to operate the Partnership under

⁸⁶ 35 P.S. § 5701.305(g).

Tobacco Settlement Investment Board

*Questions and
Answers*

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a “prudent expert standard of care.” The agreements that the Board provided to us for the other two investment managers did not specifically have the same language but the Board indicated that all venture capital investment managers are held to this standard of prudence.

With regard to other requirements, the Investment Board’s executive director informed us that she sits on the advisory/valuation committees for all four partnerships, and she attended all meetings of these committees, either in person or via teleconference. For those meetings that she attended in person, the partnership reimbursed the Investment Board for her travel expenses. Furthermore, according to the Investment Board staff, the board received the audited financial statements from each partnership each year of our audit period.

The Investment Board staff informed us that, with the assistance of the investment consultant, it monitors the venture capital investment managers’ compliance with the requirements placed in these limited partnership agreements.

Q. What is the rate of return for the Tobacco Settlement Fund and the Health Endowment Account?

A. The Department of Auditor General’s Bureau of Federal Audits, as part of its financial audit of the Tobacco Settlement Fund, reviewed and evaluated the rate of return for the Tobacco Settlement Fund. The rates of return for the Tobacco Settlement Fund as a whole were:

FY 2005-06:	9.90%
FY 2006-07:	13.25%

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Questions and
Answers

Tobacco Settlement Investment Board

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FY 2007-08: negative 2.48%, which compares to the rate of return reported by PSERS of negative 2.82%. It is also above the median rate of return of negative 4.56% for public funds with assets greater than one billion.

Q. What is the amount of and deposit date of maturing venture capital investments into the Health Endowment Account?

A. The majority of the venture capital investments are long-term investments, and the maturity dates and any earnings from these investments are not in the foreseeable future. Therefore, as of June 30, 2008, the venture capital investments from the Health Venture Account had not matured enough for a transfer of money to the Health Endowment Account to occur.

Tobacco Settlement Investment Board *Response from
Investment Board*

*Pennsylvania Department of the Auditor General
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February 2009*

**Response from
the Tobacco
Settlement
Investment
Board**

The Tobacco Settlement Investment Board's written response is reproduced on the following pages. In the response, the Board Chairman acknowledges each of the recommendations from our report.

The Department of the Auditor General thanks the Tobacco Settlement Investment Board for its cooperation during the audit process.



MEMO

TO Jack Wagner, Auditor General, Commonwealth of Pennsylvania

FROM John P. Blake, Chairman, Tobacco Settlement Investment Board

DATE 2/23/2009

RE Responses to Tobacco Settlement Investment Board Audit report

MESSAGE:

Dear Mr. Wagner,

The Tobacco Settlement Investment Board (TSIB) appreciates the thoroughness and cooperative spirit of the Auditor General's staff in conducting the Special Performance Audit of the TSIB. We also applaud the openness of the AG team in discussing the findings and recommendations covered by the audit and are confident that this cooperative approach will result in continued improvements to the transparency and efficiency of the TSIB.

The board is encouraged by the Auditor General's conclusions that the TSIB has adhered to its investment policies and statutory authority in the investment of the Tobacco Settlement funds.

Of equal importance is the report's conclusion that with respect to the 8% of total Tobacco Settlement funds that are managed by the board, investments were consistent with statutory requirements.

The recommendations in the Report provide valuable opportunities for the TSIB to improve on its policies and procedures. The board has already implemented several of the recommendations including creation of a publically accessible website and providing more expansive and reader-friendly informational materials for the board and the public.

Our formal responses to the recommendations contained in the report are as follows:

Finding ONE

Discussion Point 1

Recommendation 1 and 2: CONCUR: Additional narrative will be included in the Executive Summary of the Annual Report consistent with the recommendations.

Discussion Point 2

Recommendation: CONCUR: Website is being developed; site will be available in March, 2009.

Discussion Point 3



Tobacco
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Recommendation 4: Board members have recused themselves even when recognizing only an "appearance" of a conflict. No instances have been cited where any board member failed to disclose such a conflict or where the board failed to monitor, or enforce a conflict of interest policy. The Ethics Act, to which the board is subject, adequately defines conflicts of interest. Staff will continue to review the requirements of the Ethics Act with the board on a routine basis.

Recommendation 5: Emergency contracts are in fact, documented in TSIB contract files. The emergency procurement procedure is consistent with the Procurement code.

Discussion Point 4

Recommendation 6 CONCUR: The MOU was approved at TSIB meeting 2.23.09.

Discussion Point 5

Recommendation 7 CONCUR: Orientation material will be reviewed. Website will be used to disseminate information for training opportunities. Financial Consultants will continue to provide training. Seminars similar to the July 2008 Commonfund strategic presentation will be continued.

Discussion Point 6

Recommendation 8 and 9 CONCUR: Meeting minutes will be made more expansive.

Finding TWO

Discussion Point 1

Recommendation 10 CONCUR: Staff will document process and procedures in a staff manual.

Discussion Point 2

Recommendation 11 CONCUR: Staff has sought historical information repeatedly on existing contracts but has not been able to acquire from the prior Agency that TSIB was housed under.

Discussion Point 3

Recommendation 12 CONCUR

Discussion Point 4

Recommendation 13 CONCUR: Additional documentation will be provided as requested by Treasury.

Finding THREE

Discussion Point 1

Recommendation 14 CONCUR: Website will contain appropriate documentation including investment policies.

Discussion Point 2 No Recommendations

Discussion Point 3

Recommendation 15 CONCUR: Staff will document roles and responsibilities in process and procedures manual

Discussion Point 4

Recommendation 16 and 17 CONCUR.

Discussion Point 5 No Recommendations

Respectfully,

A handwritten signature in black ink, appearing to read "J.P. Blake". The signature is written in a cursive style with a large initial "J" and "P".

John P. Blake, Chairman
Tobacco Settlement Investment Board

Tobacco Settlement Investment Board

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*Pennsylvania Department of the Auditor General
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February 2009*

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Jack Wagner, Auditor General
February 2009*

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