NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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December 17, 2020

Michael Walden-Newman, State Investment Officer
Nebraska Investment Council
1526 K Street, Suite 420
Lincoln, Nebraska 68508

Dear Mr. Walden-Newman:

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Nebraska (State), as of and for the year ended June 30, 2020, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, we have issued our report thereon dated December 17, 2020. In planning and performing our audit, we considered the State's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

In connection with our audit described above, we noted certain internal control or compliance matters related to the activities of the Nebraska Investment Council (Council) or other operational matters that are presented below for your consideration. These comments and recommendations, which have been discussed with the appropriate members of Council's management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider Comment Number 1 (Quarterly Endowment Transfer Errors) to be a significant deficiency.

This comment will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

Draft copies of this letter were furnished to the Council to provide management with an opportunity to review and to respond to the comments and recommendations contained herein. All formal responses received have been incorporated into this letter. Responses have been objectively evaluated and recognized, as appropriate, in the letter. Responses that indicate corrective action has been taken were not verified at this time, but they will be verified in the next audit.

The following are our comments and recommendations for the year ended June 30, 2020.

1. Quarterly Endowment Distribution Errors

The State has 13 endowment funds from which the Council distributes investment income. The calculated investment income is transferred to separate funds held by the associated State agencies to expend as deemed necessary. The State's custodial bank, State Street Bank (SSB), provided the Council with a report of the distributable investment income in accordance with its agreement with the Council. Distributable investment income did not include capital gains for 7 of the 13 endowments in accordance with Op. Att'y Gen. No. 07003 (Feb. 8 2007), which states:

> *For certain fund distributions, it is necessary to distinguish between classes of investment income and between income and principal. Generally, investment receipts or amounts allocable to income include interest, dividends, and other income such as rent on lands. <u>Investment receipts allocable to principal include premiums and capital gains, whether realized or unrealized. Receipts allocable to principal ordinarily are reinvested as principal and not distributable in the absence of constitutional or statutory authority for that purpose.</u>*

(Emphasis added.) Capital gains were to remain in the endowments; however, the agreement between the Council and SSB did not address the exclusion of capital gains within the calculation. In turn, the SSB report did not exclude capital gains, causing the Council to distribute erroneously $7,538,508. This was not identified through the Council's review until the fourth quarter distribution for calendar year 2019. One equity fund held at SSB had capital gain distributions of $3,646,411 since 2017, when the fund began. When the Auditor of Public Accounts (APA) began testing of the distributions for the fiscal year 2020 audit, this quarter was selected for review. After multiple conversations questioning why the distribution calculation had changed, the Council informed the APA of the issue. Subsequently, the APA questioned whether the Council had reviewed the other SSB funds for similar issues, at which time the Council began a review and identified a second equity fund containing capital gains that had been distributed for $3,892,097 over the course of at least five years. To correct the errors, the Council calculated the necessary adjustments to reduce evenly future distributions over the following four quarters.

Furthermore, during our review of the fourth quarter distribution for calendar year 2019, we noted that the SSB report did not include five investment funds in the allocation of investment income, causing the income distribution for the calendar year 2019 to be incorrect by $74,618. The Council corrected the error after the APA identified it.

A good internal control plan and sound business practice require procedures to ensure that income distributions are accurate.

Without such procedures, there is an increased risk of material errors in the distribution of income for endowment funds.

> We recommend the Council revise procedures to ensure the quarterly income distributions are calculated correctly. In particular, capital gains should not be transferred from endowment funds, and any such monies that were distributed incorrectly should be recovered.

Council Response: The Council staff has added a step to procedures to ensure this will not happen again.

2. Investment Council Policy Violations

The Council had policies for approved broker/dealers, banks, commercial paper direct issuers, and money market funds. Two of the lists were effective during the fiscal year ended June 30, 2020. These were approved in January 2019 and December 2019 and included the following money market funds:

- JP Morgan Prime Money Market Fund
- Wells Fargo Advantage Heritage
- UBS Prime Preferred Fund.

The following table shows six transactions for money market funds that were not on the approved listing:

Transaction Type	Transaction Date	Security Name	Amount
Purchase	December 2019	Wells Fargo Government Money Market Fund	$ 25,000,000
Purchase	April 2020	JP Morgan US Government Money Market Fund	$ 34,000,000
Sale	January 2020	JP Morgan US Government Money Market Fund	$ 65,000,000
Purchase	May 2019	UBS Select Treasury Preferred Fund	$ 13,000,000
Sale	November 2019	UBS Select Treasury Preferred Fund	$ 70,000,000
Purchase	September 2019	UBS Select Treasury Preferred Fund	$ 48,000,000

The Council also placed limitations on investment ratings. The following transactions did not meet the requirements outlined in the Council's fund policy statements:

- One investment for the Operating Investment Pool fund was purchased for $16,981,640 and had a Standard and Poor's rating of AA+, which was not the highest quality rating issued by the rating service, as required in the Council's Operating Investment Pool Policy Statement (December 13, 2018), which states:

  Allowable Investments: U.S. Treasuries and U.S. Agency Notes and Debentures, Euro Time Deposits and Government Money Market Funds, all with the highest quality rating by 2 nationally recognized rating service organizations (NRSRO).

- One investment for the Health Care Endowment fund was purchased for $866,568 and had a Standard and Poor's rating of A-, which was not the highest quality rating issued by the rating service, as required in the NIC Health Care Endowment Fund Investment Policy Statement (December 13, 2018), which states:

  Allowable investments U.S. Treasuries and U.S. Agencies. Commercial Paper, Euro Time Deposits and Money Market Funds, all with the higher quality rating by 2 nationally recognized rating service organization (NRSRO). Corporate Bonds with a rating of A or better by 2 NRSRO's.

Additionally, for fiscal year 2020, the APA required rural and suburban fire districts to provide additional documentation (e.g., bank statements, bank reconciliations, meeting minutes, etc.) when submitting an audit waiver request, as allowed in Neb. Rev. Stat. § 84-304 (2020 Neb. Laws, LB 1003, § 186). While reviewing the Alma Rural Fire District's (District) request, the APA noted that the District held $68,432, as of June 30, 2020, in two brokerage accounts. Because these accounts included stock ownership in multiple private corporations, the District's investments therein appear to have conflicted with constitutional and statutory provisions, as described below.

Moreover, the Council acknowledged that, despite being referenced by State statute, there was no policy relating to political subdivision investments. The lack of such policy may have contributed to to the improper fire district investments.

Article XI, § 1, of the Nebraska Constitution provides, in relevant part, the following:

> *No city, county, town, precinct, municipality, or other subdivision of the state shall ever become a subscriber to the capital stock, or owner of such stock, or any portion or interest therein of any railroad, or private corporation, or association . . . .*

Neb. Rev. Stat. § 77-2341(1) (Reissue 2018) reads as follows:

> *Whenever any county, city, village, or other governmental subdivision, other than a school district, of the State of Nebraska has accumulated a surplus of any fund in excess of its current needs or has accumulated a sinking fund for the payment of its bonds and the money in such sinking fund exceeds the amount necessary to pay the principal and interest of any such bonds which become due during the current year, the governing body of such county, city, village, or other governmental subdivision may invest any such surplus in excess of current needs or such excess in its sinking fund in certificates of deposit, in time deposits, and <u>in any securities in which the state investment officer is authorized to invest pursuant to the Nebraska Capital Expansion Act and the Nebraska State Funds Investment Act and as provided in the authorized investment guidelines of the Nebraska Investment Council in effect on the date the investment is made. The state investment officer shall upon request, furnish a copy of the current authorized investment guidelines of the Nebraska Investment Council.</u>*

(Emphasis added.) The Nebraska Attorney General has stated the following regarding investments held by political subdivisions:

> *The Nebraska Capital Expansion Act neither authorizes nor prohibits investment in mutual funds. It deals with bank investments and related matters such as assuring all Nebraska banks and savings and loans are provided an equal opportunity to obtain state deposits. The Nebraska State Funds Investment Act's stated purpose is to formulate and establish policies to govern the practices to be followed by the state investment officer for investment of state funds. It likewise fails to specifically address mutual funds, but Neb. Rev. Stat. § 72-1246 (1990) directs that "The state investment officer shall invest in investments the nature of which individuals of prudence, discretion, and intelligence acquire or retain in dealing with the property of another . . . ."*
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> *<u>Section 77-2341 allows state political subdivisions to invest securities which the Nebraska Investment Council's investment guidelines authorize.</u> The Investment Council's guidelines authorize direct investment in U.S. Government obligations . . . .*

Op. Att'y Gen. 95041 (May 17, 1995). Good internal controls require procedures to ensure that the Council not only adheres to its own investment policies but also maintains investment guidelines applicable to political subdivisions, as referenced in State statute.

Without such procedures, there is an increased risk of inappropriate investments leading to the loss of public funds.

> We recommend the Council adhere to its own investment policies and maintain investment guidelines applicable to political subdivisions, per State statute.

Council Response: The Council staff has updated its approved broker/deal list, and the Council staff and board amended the Operating Investment Pool investment policy.

(Political Subdivision Investment Policy) The Council board and staff disagree.

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Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Council and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to the Council.

This communication is intended solely for the information and use of management, the Governor and State Legislature, others within the Council, Federal awarding agencies, pass-through entities, and management of the State of Nebraska and is not intended to be, and should not be, used by anyone other than the specified parties. However, this communication is a matter of public record, and its distribution is not limited.

Kris Kucera

Kris Kucera, CPA, CFE
Audit Manager