

**JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY**

COMMISSION DRAFT

**Special Report:
Certain Personnel
Issues at the Virginia
Retirement System**

July 11, 2005

In Brief...

Special Report: Certain Personnel Issues at the Virginia Retirement System

The Retirement System Oversight Subcommittee of the Joint Legislative Audit and Review Commission (JLARC) directed staff to complete a special study of two personnel issues at the Virginia Retirement System (VRS). These issues related to the potential conflict of interests of a member of the Board of Trustees relative to his interest in seeking the Chief Investment Officer (CIO) position, and the handling of the former director's severance agreement.

JLARC staff found that the CIO search committee promptly and appropriately addressed the potential conflict of interests issue.

With regard to the handling of the former director's severance, this review found that the severance agreement was executed by the former Board chairman without the full knowledge and proper authorization of the Board. The Board also failed to carry out its duty to monitor the final disposition of the terms for the director's retirement. Therefore, the agreement may be invalid. JLARC staff also found that the terms of the agreement appear excessive in comparison to normal practices, such as those outlined in the Workforce Transition Act (WTA). To avoid the problems identified in this review, every Board member needs to be more actively involved in the decisions and activities of the Board. In addition, staff need to be more proactive in providing guidance to the Board.

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Philip A. Leone

*Members of the Retirement System Oversight Subcommittee

JLARC Staff for This Report

Glen S. Tittermary, Deputy Director
 Patricia S. Bishop, VRS Oversight Analyst

Commission Draft

**SPECIAL REPORT: CERTAIN
PERSONNEL ISSUES AT THE VIRGINIA
RETIREMENT SYSTEM**

**Received and
Authorized for
Printing**

This document is the Commission draft of the Joint Legislative Audit and Review Commission Special Report: Certain Personnel Issues at the Virginia Retirement System. This draft has been assembled for discussion and factual review. Do not publish or release any material contained in this document, because it is subject to additional verification and editorial review.

**Joint Legislative Audit and
Review Commission**

July 11, 2005



Special Report: Certain Personnel Issues at the Virginia Retirement System

On June 24, 2005, the Retirement System Oversight Subcommittee of the Joint Legislative Audit and Review Commission (JLARC) directed staff to complete a special study of two personnel issues at the Virginia Retirement System (VRS). These issues related to: (1) the potential conflict of interests of a member of the Board of Trustees relative to his interest in seeking the Chief Investment Officer position, and (2) the handling of the former director's severance agreement at the time of his retirement. These potential issues were brought to the attention of JLARC staff in the course of its normal oversight of the retirement system. JLARC staff notified the Chairman of the Commission of the concerns. At the direction of the Chairman, the Retirement System Oversight Subcommittee met and authorized staff to proceed with an examination of the two issues (Appendix A).

To complete this review, JLARC staff reviewed relevant documents such as Board and committee minutes, memoranda, email, contracts, and personnel and financial records. Interviews were conducted with eight members of the Board of Trustees, the VRS staff, several members of the CIO search committee, staff of the search firm assisting in the hiring of the CIO, and staff of the Office of the Attorney General. Staff also completed a review of relevant sections of the *Code of Virginia*. Staff with the Auditor of Public Accounts assisted with the review of payroll records and other supporting documentation.

VRS Hiring Practices Related to Members of the Board and Advisory Committees

VRS is currently in the process of filling the position of Chief Investment Officer (CIO) and a search committee has been created to review the candidates for the position. The six members of the search committee are members of either the Board of Trustees or the VRS Investment Advisory Committee. The committee is being assisted by a search firm, hired by VRS to identify potential candidates for the position.

At the meeting of the search committee on June 17, 2005, the representative of the search firm asked for clarification of the protocol for consideration of internal candidates. The firm noted that the name of one member of the search committee, who is also a member of the Board of Trustees, had been suggested as a potential candidate. At that time, the member was not a candidate, and was not being offered by the firm as one of the nine possible applicants for the position. When asked by the chair of the search committee, however, the member of the search committee said he would consider making himself a candidate.

The search committee resolved the conflict of interests issue promptly and appropriately ...

Concerns were immediately raised by the search committee about the potential conflict of interests in having a member of the committee as a candidate for the position. Counsel from the Office of the Attorney General advised that a member of the search committee could not be a candidate for the position. The search committee resolved the conflict of interests issue promptly and appropriately by asking the member to resign from the search committee and by adopting a resolution prohibiting any consideration of members of the Board of Trustees or the Investment Advisory Committee for the CIO position. The member resigned from the search committee and later elected not to be a candidate for the position when advised that he would have to resign from the Board of Trustees to do so.

While the immediate situation with regard to the selection of a CIO was promptly resolved it raises a general concern about the process for hiring staff in leadership positions. The approach of turning to a member of the Board of Trustees to fill an open staff position had been used by VRS to fill the position of director in 2002. In that instance, the Board hired the sitting chairman as director. Apparently, no concerns were raised at that time by either the Board or the director search committee.

While the Board may have acted in good faith by offering the director's position to the sitting chairman, in retrospect it could be viewed as having been the result of improper influence and not in the best interest of the retirement system. It also appears to be inconsistent with a provision of the Board of Trustees Code of Ethics and Conduct, which is a part of its Governance Policy. The Code of Ethics requires that, "Board members will not use their position to obtain employment at VRS for themselves, family members, or close associates." In the case of the former director, he did not actively seek the position, but would not likely have otherwise been a candidate were it not for his position as chairman of the Board. To avoid the appearance of "insider deals" and improper influence, the Board should adopt a policy prohibiting the hiring of members of the Board of Trustees or the Investment Advisory Commit-

tee to any position at VRS for at least a year after their service on those bodies.

Recommendation (1). Because of the potential for conflicts of interests and the appearance of improper action by the Board, the Board of Trustees should adopt a policy prohibiting members of the Board or the Investment Advisory Committee from being eligible for employment to any full-time position at VRS for one year after the end of service on the Board or the committee. If the Board chooses not to enact such a policy, the General Assembly may wish to restrict the practice by statute.

Recommendation (2). The members of the Board of Trustees and the Investment Advisory Committee should commit to ongoing training by the VRS counsel on the requirements of the Conflicts of Interests Act and the Board of Trustees' Governance Policy. Counsel and senior VRS staff must also exercise their professional responsibility to ensure Board compliance with the Act.

Severance Agreement for the Former Director

A second issue relates to the negotiation and execution of a severance agreement for the former director. Based on a review of relevant documents and interviews with members of the Board of Trustees and VRS staff, JLARC staff found that the severance agreement was executed without the full knowledge and proper authorization of the Board. Therefore, the agreement may be invalid. It also appears that both the original employment contract for the former director and the severance agreement were handled by VRS as confidential documents, which does not comply with the requirements of the Virginia Freedom of Information Act. In addition, the terms of the agreement appear excessive in comparison to normal practices, such as those outlined in the Workforce Transition Act (WTA).

The Board Chairman Executed the Severance Agreement without the Full Knowledge and Authorization of the Board. On December 1, 2004, the chairman of the Board of Trustees and the director signed an agreement terminating the director's employment effective April 1, 2005 (Appendix B). The director subsequently announced his retirement. The agreement provided for a lump sum payment equal to two years of salary, the payment of unused leave, and the acceleration of the purchase by VRS of six months of prior service.

According to the former chairman of the Board of Trustees, he negotiated and executed the severance agreement with the di-

rector on behalf of the Board and with its authorization. The Board had met in closed session on November 24, 2004 to discuss the pending retirement of the director. It was in this closed session that the chairman appears to have been asked to negotiate the terms of the director's departure and to determine a date for his leaving. The members of the Board interviewed by JLARC staff agreed that the former chairman was asked to determine the details regarding the director's departure.

There remains some disagreement among Board members, however, about the nature of the discussion relative to the terms of any severance. The former chairman told JLARC staff that he presented the Board with two options outlining the potential liability VRS might have for payment of severance provided for in the employment contract for the director. Other Board members claim that there was no discussion of any severance provisions. Several other Board members noted that they understood that the director had an employment contract and that the contract would address the terms of any termination or separation. There appears to have been at least some general discussion of severance, because the vice-chairman at the time recalls noting his objection to the payment of any severance, and his surprise that no other members raised any objection. The former chairman also noted in his interview with JLARC staff that the vice-chair had raised an objection to the payment of severance.

According to the former chairman, he believed that the consensus of the Board was for him to negotiate the termination agreement consistent with the terms of the director's employment contract (Appendix C). However, it is clear from the Board's minutes and from interviews with Board members, that upon returning to open session, the Board did not pass a resolution directing the chairman to execute any such agreement on behalf of the Board.

While the former chairman may have believed he had authorization to execute the termination agreement for the Board, without a formal resolution in public session, he had no authorization to act. Statute is clear on the duties and authority of the chairman. Section 51.1-124.20(D) of the *Code of Virginia* enumerates the chairman's duties:

The chairman shall (i) preside over meetings of the Board; (ii) communicate on behalf of the Board to outside entities interested in the Retirement System; and (iii) perform additional duties as may be set by resolution of the Board.

This limitation on the authority of the chairman was one of the primary reforms of the retirement system resulting from the JLARC review of VRS governance in 1993. Interference with the staff and other abuses of power by the chairs in the early 1990s were specifically addressed by the General Assembly with its enactment of the defined duties of the chair. It was the intent of the Legislature that the VRS chairman would have no independent executive authority. The General Assembly also limited the authority of the Investment Advisory Committee, restricting its role to that of advising and making recommendations to the Board. The Board can delegate authority to the chairman and committees, but it must do so by resolution in an open meeting. Ultimately, however, responsibility rests with the Board of Trustees. Despite this requirement, the Board did not adopt a resolution directing or authorizing the chairman to execute the severance agreement with the director.

While the former chairman appears to have erred in executing the agreement without the full knowledge and authorization of the Board, the Board failed to discharge its duty to inquire about, understand, and monitor the termination of the director.

Moreover, at subsequent meetings the Board never approved the final severance agreement in open session. According to seven of eight trustees interviewed by JLARC staff, they were not aware of the specific provisions of the severance agreement until informed about them during the course of this JLARC review. While the former chairman appears to have erred in executing the agreement without the full knowledge and authorization of the Board, the Board failed to discharge its duty to inquire about, understand, and monitor the termination of the director. There appears to have been no follow-up by the Board regarding the terms of the director's departure. Given circumstances at the time, the Board should reasonably have been expected to inquire about such terms.

Since the severance agreement was executed without the authorization of the Board of Trustees, it may be invalid. This places in question the payments made to the former director as well as the accelerated purchase of service. To address this matter, the Board needs to act promptly to either recover the funds paid to the former director or to ratify retroactively the severance agreement.

Recommendation (3). The Board of Trustees of the Virginia Retirement System should act promptly to either recover the funds paid to the former director but never authorized by the Board, or authorize the severance benefits as provided for in the termination agreement dated December 1, 2004.

The Severance Provision in the Original Employment Agreement Had Lapsed. The original contract for employment of the director, which was executed in February 2002, called for up to two years of severance if the director was terminated in the first two years. The obvious purpose of this provision was to protect the director from a potential loss of in-

come should the Board terminate his employment early. This could be viewed as a reasonable incentive to recruit an individual not otherwise inclined to abandon his career for a new employer. The original employment agreement was to “continue at the pleasure of the VRS beyond the initial period unless terminated earlier” by the director. However, there was no provision for severance beyond the initial two-year period.

The former chairman reported to JLARC staff that a subsequent employment contract was negotiated with the former director, but never signed by either party. According to the former chairman, this agreement was approved by the Board of Trustees, but because of subsequent changes to the document, it was never signed. The former chairman explained that the severance provisions included in the December 2004 agreement were as a result of a legal obligation to abide by the provisions of this approved, but unsigned employment contract. However, a review of Board minutes by JLARC staff found no evidence that this second employment agreement was ever considered or approved by the Board in open session. Moreover, the other members of the Board appeared to be unaware of this renegotiated employment contract.

... since the director was retiring and had served in his position only three years, the additional benefit of two years of severance appears unwarranted.

Since the original provision for severance had lapsed early in 2004, and the subsequent employment agreement in 2004 was never approved by the Board or signed by either party, there was no obligation for severance as a part of any termination agreement. In fact, since the director was retiring and had served in his position only three years, the additional benefit of two years of severance appears unwarranted.

The Severance Provision in the Revised Agreement Was Excessive. Under the terms of the severance agreement executed in December 2004, the VRS purchased six months of service credit on behalf of the director, and agreed to pay two year’s salary as severance upon his retirement. The agreement also provided for the payment of unused leave, which is standard for the retirement or termination of any State employee.

The purchase of six months of service was valued at \$3,289 and was an acceleration of purchases of service originally authorized by the Board in 2003. The total value of the service purchased on behalf of the former director, including the last six months, was \$22,312. Since the Board had approved the original purchase of service, the changes to that action should also have been approved by the Board. However, there is no record in the Board’s minutes that it authorized any acceleration of the purchase of service, and the Trustees interviewed by JLARC staff confirmed that the acceleration was not approved.

The gross severance amount was \$263,122. The director had been employed at VRS less than three years at the time of this agreement. His departure from VRS was not under the terms of the Workforce Transition Act (WTA), which provides for severance when employees are involuntarily terminated. For those employees with more than 15 years of service, the WTA provides for two weeks of salary for every year of service, up to a maximum of 36 weeks. In comparison to the terms of the WTA, the agreement for the former director of VRS appears excessive.

The unauthorized offer of severance in excessive amounts was possible because the Board did not properly monitor the process under which the director terminated his service, and because VRS does not have a policy on the provision of severance for those employees who serve at the pleasure of the Board of Trustees. However, VRS employees are eligible for the benefits provided under the Workforce Transition Act (WTA). For employees who serve at the pleasure of the Board, there is no guidance from the Board on the circumstances under which the payment of severance is considered appropriate, or on the amounts that should be offered. The payment of severance to employees who are retiring, for example, is not a normal practice for Virginia State employees. And, severance of two year's salary for an employee who has been employed for only three years would be considered excessive under any circumstances.

Recommendation (4). The Board of Trustees should adopt a policy on the use of severance pay for VRS employees. The policy should establish the purpose of severance, when severance may be offered, and the appropriate amounts that may be offered.

Attempts to Avoid Disclosure Are Inconsistent with FOIA. Section 2.2-3705.8 of the *Code of Virginia*, a section of the Virginia Freedom of Information Act (FOIA), requires the disclosure of contracts between a public body and its officers or employees, as well as the records of the position, job classification, official salary or rate of pay of any official or employee of a public body. Despite this clear limitation on the protection of personnel records, both the original employment contract for the former director and the severance agreement were marked as confidential. The employment contract is marked at the top as "*Strictly Private and Confidential.*" Item 4 of the severance agreement calls for VRS and the former director to "keep the terms of this Revised Agreement confidential to the extent permitted by law." Under the provisions of FOIA, the documents are not protected from disclosure.

The manner in which the former chairman of the Board negotiated the severance agreement and directed staff to process the subsequent transactions also appears to have been intended to prevent disclosure of the agreement as required by law. The negotiation was carried out by the former chairman without discussion of the details of the severance agreement with other members of the Board. In addition, the former chairman directed VRS staff not to discuss the agreement with anyone. Staff subsequently processed the severance payment in the VRS payroll system without attaching the agreement as documentation. VRS staff told JLARC staff that the agreements were thought by VRS to be protected from disclosure because they were personnel records.

Recommendation (5). The members of the Board of Trustees, the Investment Advisory Committee, and the VRS staff should be trained by the VRS counsel on the requirements of the Freedom of Information Act (FOIA). The Board should express its sense by resolution that the Board, its committees, and the VRS staff will always comply with the requirements of the Act. Whenever Board or committee actions could conflict with FOIA, the VRS director, the CIO, and counsel should promptly advise the Board or committee of the requirements of the Act.

Conclusion

Every member of the Board must take an active interest in the important policy decisions that are the responsibility of the Board.

In the early 1990s, various actions of the Board of Trustees worked to erode the public's confidence in the ability of the Board to effectively govern VRS. The reforms enacted in response to those concerns provided a foundation for strong leadership, effective administration, and sound stewardship of public funds. It is the duty of each individual member of the Board, however, to discharge their responsibilities in a manner that will prevent the Board's ability to govern from being called into question. Every member of the Board must take an active interest in the important policy decisions that are the responsibility of the Board. In fact, this is required in the Board of Trustees' Code of Ethics and Conduct, which states that members should be prepared for the Board's work, actively participate in the Board's meetings, and "maintain a continuing awareness of the actions and activities of the Board and its committees." (One member of the Board reported that he has refused to sign the Code of Ethics and Conduct, because he disagrees with some of its provisions.)

It is also important for the director, the CIO, and other senior VRS staff to provide guidance to the Board to ensure that it is in compliance with the requirements of all laws and regulations. In order for this to occur, the Board and VRS manage-

ment need to encourage a more open environment of communication with the staff. The issues raised in this report might have been avoided if the concerns of staff, eventually communicated to JLARC staff during the course of this review, instead had been presented to VRS management and the Board. Without such open communication between the Board and its staff, the Board will find itself at risk for avoidable mistakes and misunderstandings.

Appendix A

Study Mandate

Motion approved by the Retirement System Oversight Subcommittee on June 24, 2005:

In accordance with the responsibilities outlined in the Virginia Retirement System Oversight Act (§30-78 *et seq.* of the *Code of Virginia*) and under the direction of the Retirement Oversight Subcommittee of the Joint Legislative Audit and Review Commission (JLARC), the JLARC staff is directed to conduct a review of personnel-related issues at the Virginia Retirement System (VRS). The Commission requests that staff conduct its review expeditiously in order to provide a report to JLARC at its July 11, 2005 meeting.

Appendix B

Severance Agreement

Dated December 1, 2004

AMENDMENT TO FEBRUARY 2, 2004 EMPLOYMENT AGREEMENT

On February 2, 2004 an agreement ("Original Agreement") was made effective that date by and between the VIRGINIA RETIREMENT SYSTEM (VRS) and W. Forrest Matthews, Jr. (Matthews) to employ Matthews as Director.

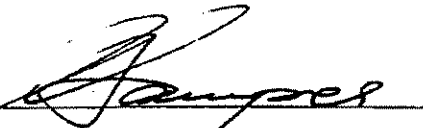
WHEREAS, Matthews and the VRS Board desire to amend the Original Agreement, and

WHEREAS, the VRS and Matthews desire to terminate their existing relationship effective April 1, 2005.

NOW, THEREFORE, the parties hereto mutually agree as follows:

1. The VRS will pay Matthews a sum equal to two (2) years of his current annual salary on April 1, 2005.
2. The VRS will pay Matthews for up to the maximum hours permitted of unused leave and VRS will be flexible in allowing Matthews to utilize any other leave available between the date of this Agreement ("Revised Agreement") and April 1, 2005.
3. The VRS will facilitate and pay for the purchase of six (6) months of prior service.
4. The VRS and Matthews agree to keep the terms of this Revised Agreement confidential to the extent permitted by law.
5. The terms of this Revised Agreement shall be effective on the date executed by each of the parties.

VIRGINIA RETIREMENT SYSTEM

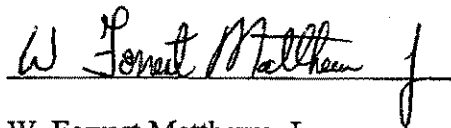
By 

Alfonso I. Samper, Chairman

By Authority of the

Board of Trustees

Date: December 1, 2004



W. Forrest Matthews, Jr.

Date: December 1, 2004

**Appendix C
Original Employment
Agreement Dated
February 4, 2002 and
Unsigned Revised
Employment Contract
(Undated)**

Strictly Private and Confidential

EMPLOYMENT AGREEMENT

THIS AGREEMENT is made effective on the date provided within by and between the VIRGINIA RETIREMENT SYSTEM (VRS) and W. Forrest Matthews, Jr. (Matthews).

WHEREAS Matthews has had significant experience with the many affairs of the VRS, including service as a Board member and Chairman of VRS, and


WHEREAS the VRS desires to obtain the benefit of such experience by employing Matthews as Director of the VRS,

NOW THEREFORE, the parties hereto mutually agree as follows:

1. The VRS will pay salary of One Hundred Twenty-five Thousand Dollars (\$125,000), or the amount set forth in the 2002 Appropriations Act, whichever is greater.
2. The VRS will provide for bonus pay consistent with the 2002 Appropriations Act.
3. Vacation and other leave calculations shall recognize years of service with the City of Richmond and Henrico County with a minimum vacation of four weeks. Retirement benefits shall be determined in accordance with the provisions of Virginia Code Section 51.1-155.1
4. Matthews agrees to abide by the policies of the VRS and acknowledges he serves at the pleasure of the Board.
5. For a period of two years from date of employment, if Matthews is terminated by the Board without cause, Matthews shall be entitled to receive a full year's pay based on the salary then in effect; and if the remaining term under this Agreement is more than 12 months, Matthews shall be entitled to that additional amount also.
6. The term of this Agreement shall commence on March 13, 2002 and shall continue at the pleasure of the VRS beyond the initial period unless terminated earlier by Matthews.

VIRGINIA RETIREMENT SYSTEM

by


C. B. Walker, Vice Chairman
By Authority of the
Board of Trustees

Date:

2/04/02


W. Forrest Matthews, Jr.

Date:

2/04/02

EMPLOYMENT AGREEMENT

THIS AGREEMENT is made effective on the date provided within by and between the VIRGINIA RETIREMENT SYSTEM (VRS) and W. Forrest Matthews, Jr. (Matthews).

WHEREAS, Matthews has had significant experience with the many affairs of the VRS, including service as a Board member and Chairman of VRS, and

WHEREAS, the VRS desires to obtain the benefit of such experience by employing Matthews as Director of the VRS,

NOW, THEREFORE, the parties hereto mutually agree as follows:

1. The VRS will pay a minimum salary of One Hundred Twenty-five Thousand Dollars (\$125,000), or the amount set forth in the Appropriation Act, whichever is greater. If not set forth in the Appropriation Act, the Board of Trustees may establish a salary above the minimum.

2. The VRS will provide for bonus pay consistent with the Appropriation Act, or if not set forth in the Appropriation Act, a bonus of five (5) percent or more.

3. Vacation and other leave calculations shall recognize thirty (30) years of service, with a minimum vacation of four (4) weeks. Retirement benefits shall be determined in accordance with the provisions of the *Code of Virginia*, § 51.1-155.1.

4. Matthews agrees to abide by the policies of the VRS and acknowledge he serves at the pleasure of the Board.

5. For a period of five (5) years from the date of this agreement, if Matthews is terminated by the Board without cause, Matthews shall be entitled to receive a full year's pay based on the salary then in effect, including accumulated leave, and, if the remaining term under this Agreement is more than twelve (12) months, Matthews shall be entitled to no more than one (1) additional year's pay.

6. The term of this Agreement shall commence on _____ and shall continue at the pleasure of the VRS beyond the initial period unless terminated earlier by Matthews.

VIRGINIA RETIREMENT SYSTEM

By _____
Alfonso I. Samper, Chairman
By Authority of the
Board of Trustees

W. Forrest Matthews, Jr.

Date: _____

Date: _____

Appendix D

Agency Response

JUL 07 2005



1200 East Main Street, P.O. Box 2500, Richmond, Virginia 23218-2500
Telephone: (804) 344-3120 Fax: (804) 786-1541

Robert P. Schultze
Director

July 7, 2005

Mr. Philip A. Leone
Director
Joint Legislative Audit and Review Commission
Suite 100
General Assembly Building
Richmond, VA 23219

Dear Mr. Leone:

Thank you for furnishing an exposure draft of the Special Report: Certain Personnel Issues at the Virginia Retirement System. Paul Timmreck and I have reviewed the draft and, subject to the minor corrections we noted, find it to be factually accurate to the best of our knowledge.

As you know, Mr. Timmreck has scheduled a meeting next week for the VRS Board of Trustees to be briefed by JLARC staff. I trust the Board will act prudently on the report's recommendations.

Thank you for raising the issues and for conducting your review in a thorough and professional manner. The report will be of immense help to the Board as it deals with the several matters under consideration.

Sincerely yours,

A handwritten signature in cursive script that reads 'Robert P. Schultze'.

Robert P. Schultze
Director

Attachment