STATE OF ILLINOIS

OFFICE OF THE AUDITOR GENERAL

MANAGEMENT AUDIT OF THE

COLLEGE ILLINOIS! PREPAID TUITION PROGRAM'S ADMINISTRATIVE OPERATIONS

MAY 2012

WILLIAM G. HOLLAND

AUDITOR GENERAL

SPRINGFIELD OFFICE:
ILES PARK PLAZA
740 EAST ASH • 62703-3154
PHONE: 217/782-6046
FAX: 217/785-8222 • TTY: 888/261-2887

CHICAGO OFFICE:
MICHAEL A. BILANDIC BLDG. • SUITE S-900
160 NORTH LASALLE • 60601-3103
PHONE: 312/814-4000
FAX: 312/814-4006

OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

To the Legislative Audit Commission, the Speaker and Minority Leader of the House of Representatives, the President and Minority Leader of the Senate, the members of the General Assembly, and the Governor:

This is our report of the Management Audit of the College Illinois! Prepaid Tuition Program's administrative operations.

The audit was conducted pursuant to House Resolution Number 174, which was adopted April 14, 2011. This audit was conducted in accordance with generally accepted government auditing standards and the audit standards promulgated by the Office of the Auditor General at 74 Ill. Adm. Code 420.310.

The audit report is transmitted in conformance with Section 3-14 of the Illinois State Auditing Act.

WILLIAM G. HOLLAND
Auditor General

Springfield, Illinois
May 2012

SPRINGFIELD OFFICE:
ILES PARK PLAZA
740 EAST ASH • 62703-3154
PHONE: 217/782-6046
FAX: 217/785-8222 • TTY: 888/261-2887

CHICAGO OFFICE:
MICHAEL A. BILANDIC BLDG. • SUITE S-900
160 NORTH LASALLE • 60601-3103
PHONE: 312/814-4000
FAX: 312/814-4006

OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

To the Legislative Audit Commission, the Speaker and Minority Leader of the House of Representatives, the President and Minority Leader of the Senate, the members of the General Assembly, and the Governor:

This is our report of the Management Audit of the College Illinois! Prepaid Tuition Program's administrative operations.

The audit was conducted pursuant to House Resolution Number 174, which was adopted April 14, 2011. This audit was conducted in accordance with generally accepted government auditing standards and the audit standards promulgated by the Office of the Auditor General at 74 Ill. Adm. Code 420.310.

The audit report is transmitted in conformance with Section 3-14 of the Illinois State Auditing Act.

WILLIAM G. HOLLAND
Auditor General

Springfield, Illinois
May 2012

SUMMARY REPORT DIGEST

COLLEGE ILLINOIS! PREPAID TUITION PROGRAM'S ADMINISTRATIVE OPERATIONS

MANAGEMENT AUDIT

Release Date: May 2012

SYNOPSIS

We identified several deficiencies in the administrative operations of the College Illinois! Prepaid Tuition Program (Program) including a procurement process that lacked consistency, transparency, independence, documentation, and compliance with procurement rules and the Procurement Code. We also identified management issues including a lack of support for actuarial assumptions used when setting contract prices, not having a set policy for how Program costs are allocated, and not utilizing key controls governing the Program's investments.

Specifically we found the following:

- The Illinois Student Assistance Commission (ISAC) circumvented the Illinois Procurement Code by selecting two investment managers outside of the normal procurement process. The procurement process was also circumvented when awarding a contract to perform due diligence services on the two investment managers.
- ISAC did not comply with its own conflict of interest policy. There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager while the selection process involving that investment manager was still ongoing.
- The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the Program sought investment managers for alternative investments. The role of the independent Investment Consultant was reduced, including the removal of its role in evaluating proposals.
- We noted several issues with the procurements including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the RFP, and lack of support justifying the number of proposers selected for award.
- Internal controls over the investment process were not functioning properly including the Investment Committee that was created but not formally established, the Portfolio Committee that was not fulfilling its requirements, and the Investment Advisory Panel failing to fulfill its statutory duties. In addition, the Investment Advisory Panel raised questions or concerns on certain investment issues which were not communicated to members of the Commission.
- ISAC could not provide support for how actuarial assumptions, such as investment return and future contract sales, were established or any rationale to support the assumptions used.
- Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011 due to a substantial increase in investment management fees and increases in both direct and shared payroll expenses. Fees collected from purchasers of tuition contracts covered only 7 percent of operating costs in fiscal year 2011.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

REPORT CONCLUSIONS

The procurement process (during the period where program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011) lacked consistency, transparency, independence, documentation, and compliance with procurement rules and the Procurement Code. In addition, the lack of implementation of the agency's conflict of interest policy led to the appearance of multiple conflicts, including multi-million dollar investments into funds where a staff member had private investments.

Although the Prepaid Tuition Fund had an annual average return of 3.5 percent from its inception in 1998, the actuarial assumed rates for 2006 to 2011 ranged from 7.5 percent to 9.25 percent. Fees collected from purchasers of tuition contracts covered only 7 percent of operating costs in fiscal year 2011. In fact, as program costs increased (from $6.4 to $18.1 million from fiscal years 2006 to 2011), the fees received actually declined (from $2.3 to $1.4 million).

Background

Established in 1997, the College Illinois! Prepaid Tuition Program (College Illinois or Program) allows participants to purchase a contract that prepays the full cost of tuition and mandatory fees at Illinois public universities and Illinois community colleges. The Illinois Student Assistance Commission (ISAC) administers the Program. ISAC's duties include investing Program funds with investment managers. The funded ratio of the Program has declined from 93.3 percent in 2007 to 70.5 percent in the most recent actuarial report which is as of June 30, 2011. House Resolution Number 174 directed the Auditor General to conduct a management audit of the Program. (pages 8-12)

Investing College Illinois Funds

The Illinois Student Assistance Commission circumvented the Illinois Procurement Code by selecting two investment managers outside of the normal procurement process.

The Illinois Student Assistance Commission circumvented the Illinois Procurement Code by selecting two investment managers (Kennedy Wilson and Lyrical-Antheus Realty Partners) outside of the normal procurement process. As discussed below, **it was later discovered that the former Director of Portfolio Management had become a limited partner in one of the investments**. During fiscal year 2011, these two investment managers received more than $2.6 million in investment fees.

The procurement process was also circumvented when awarding a contract to Mesirow Financial Investment Management (Mesirow) to perform due diligence services on

The procurement process was also circumvented when awarding a contract to perform due diligence services on the two investment managers.

the two investment managers. The fee structure for the due diligence services may have created an incentive for Mesirow to recommend the investments. Mesirow completed the first due diligence review prior to a contract to perform the work being in place. (pages 48-52)

ISAC did not comply with its own conflict of interest policy. A conflict of interest requirement contained in the Program's Investment Policy, which required an annual conflict of interest attestation by Commissioners and employees authorized to make investment decisions, was never implemented. We noted potential conflict of interest issues which included the following:

- There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. Both involved investment firms that were selected as investment managers, one of which received $20 million in funding.

In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager, while the selection process involving that investment manager was still ongoing.

- **In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager, Balestra Capital, while the selection process involving that investment manager was still ongoing** – specifically, a family partnership in which the Director of Portfolio Management had an economic interest made a $500,000 investment in Balestra Capital. He was also a member of the evaluation team that selected Balestra Capital.

- In another potential conflict of interest, the former Director of Portfolio Management introduced an investment with Lyrical-Antheus Reality Partners to ISAC and then, after leaving ISAC, became a limited partner in the investment. (pages 52-57)

In examining investment manager files, we noted one investment manager, Reynoso Asset Management, was provided funding that exceeded the amount authorized by $10 million. We also noted that a private equity investment of $14 million was made with a single company, Fisker Automotive, despite several risks outlined in the Subscription Agreement. (pages 58-62)

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments.

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments. The selection of investment managers changed in several distinct ways:

The evaluation committee became less diversified in later procurements, consisting of only ISAC staff.

- The makeup of the evaluation committee changed over the time period examined. The evaluation committee was more diversified in the earlier procurements including a Commissioner and a member of the Advisory Panel, in addition to staff at ISAC. Later procurements included only ISAC staff on the evaluation committee. Despite ISAC's State Purchasing Officer previously advising against it, the Executive Director of ISAC was included on the evaluation committee for three procurements. Participating on the evaluation team could allow the Executive Director to assert undue influence over the process.

The Investment Consultant assisted in evaluating proposals but was removed from this role in later procurements.

- For earlier procurements, Marquette Associates, the Program's Investment Consultant, assisted in evaluating proposals but was removed from this role in later procurements. It is unclear why ISAC removed the Investment Consultant from the process. One effect was creating greater control for the now smaller evaluation teams, consisting solely of ISAC staff, over the selection process.

The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session.

- The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session. By moving these discussions to closed session, ISAC removed transparency from the process.

We reviewed all 14 procurements involving the selection of investment managers during fiscal years 2006 through 2011. We noted several issues with the procurements:

We noted several issues with the procurements including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the RFP, and lack of support justifying the number of proposers selected for award.

- For the interviews/presentations of the finalists, none of the 14 procurements examined contained documentation on who attended or what was discussed.

- The procurement files lacked evidence of discussions regarding the rationale for the number of proposers selected for award. The number of winning vendors ranged from 1 to 13. The justification and rationale for the number selected was unclear.

- The procurement files were incomplete. Three of the 14 procurements lacked documentation on the initial scoring of the proposers and 1 of 14 lacked final scoring. Many evaluation forms lacked notes to justify the scores given.

- We noted mistakes during the scoring process for 4 of the 14 procurements. Some of these errors impacted the firms selected.

- For 3 of the 14 procurements, the evaluation criteria were changed to total only 450 points instead of the 500 points outlined in the Request for Proposals. (pages 35-47)

The Investment Advisory Panel, established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission.

The Investment Advisory Panel (Panel), established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission. The Commission members approve all investment decisions and may lack the expertise that members of the Panel possess. Specifically, the Panel raised concerns over changing the Investment Policy to allow direct private equity investment. While the Panel raised concerns to the senior staff at ISAC, if those concerns are not, in turn, communicated to the Commission, the purpose of the Panel is negated.

In addition, the Panel failed to fulfill its statutory duties by not meeting at least twice annually as required by the Illinois Prepaid Tuition Act. The Panel also did not meet publicly with the Commission at least once annually to discuss issues and concerns relating to the Illinois Prepaid Tuition Program. There was also at least one vacancy on the seven-member Panel throughout the audit period. (pages 29-35)

The College Illinois Program had several other weaknesses in its internal controls over the investment process. These included:

- The Commission has not approved a new Investment Policy since January 2010 which violates the statutory requirement of annually adopting a comprehensive investment plan.

- The Portfolio Committee, which took over the rebalancing function from the independent Investment Consultant, failed to meet monthly as required in the Investment Policy and had not met since October 2010.

- The Investment Committee, which was to consist of at least two Commission members, was not formally established. (pages 23-28)

Other Issues with Program Administration

The number of employees working for the College Illinois Program increased significantly over the six year period.

The number of employees working for the College Illinois Program increased significantly over the six year period. Twelve of the 20 employees hired during that time period were principal administrative appointments which are positions hired at the discretion of the Executive Director. Two of the positions created were investment positions for which it was not clear what duties and responsibilities were performed. Both of these positions have subsequently been eliminated.

Other testing results showed that 46 percent (11 of 24) of the employees tested lacked position descriptions that listed the education and experience needed for the positions making it impossible to determine if employees were qualified. Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated.

One employee, the Director of Portfolio Management, voluntarily resigned his position effective July 21, 2010. Five days later, on July 26, 2010, the Executive Director of ISAC signed a voluntary separation agreement with the Director of Portfolio Management that included a lump sum payment of $24,166. (pages 64-69)

The annual report, which includes the actuarial report, is one of the primary vehicles for presenting meaningful information on the College Illinois Prepaid Tuition Program. While the reports contain the minimal required statutory information, they do not contain further information required by the Investment Policy. The reports also do not contain certain information that would be useful to contract holders and others who are evaluating the Program. (pages 70-72)

ISAC could not provide support for how actuarial assumptions were established or any rationale to support the assumptions used.

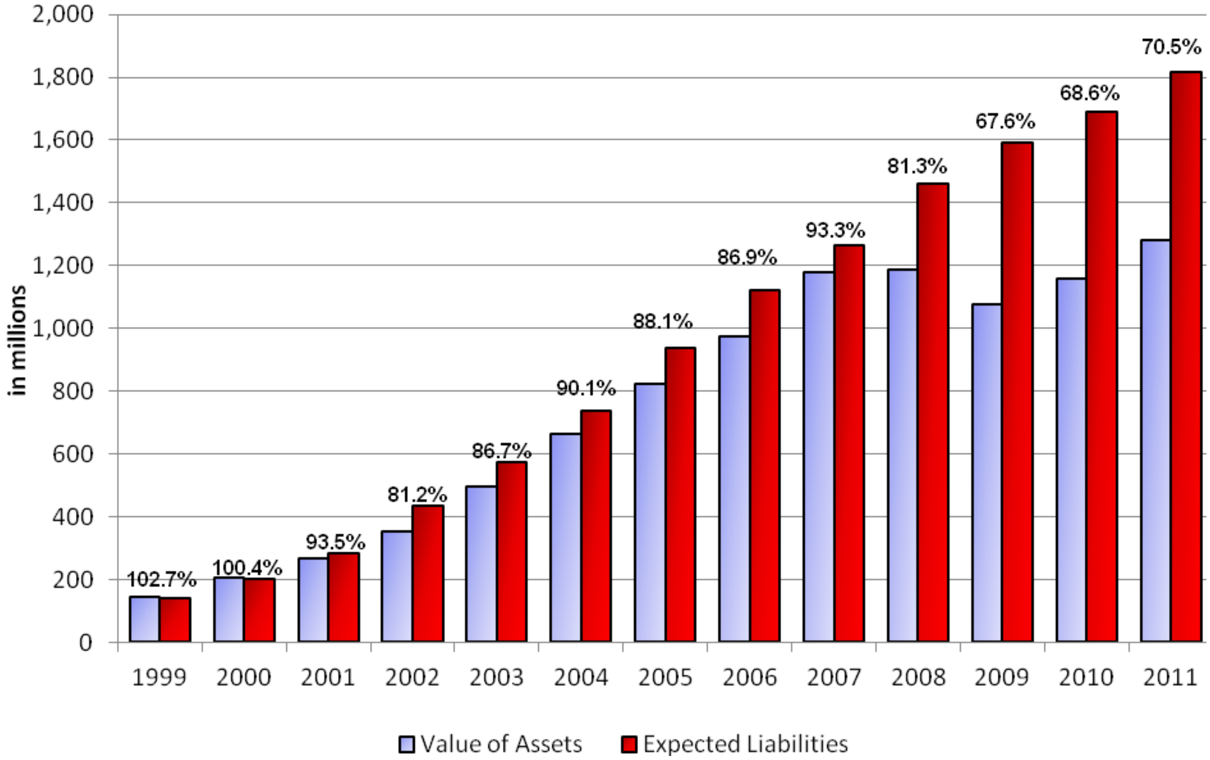
ISAC is responsible for the actuarial assumptions used in both the actuarial report and to set tuition contract prices. **ISAC, however, was unable to provide documentation for how certain assumptions were established or any rationale to support the assumptions used.**

- The investment return assumption of 9.25 percent, which was used in the fiscal year 2010 report, was lowered to 7.50 percent in the fiscal year 2011 report. The lowering of the investment assumption coincided with the change in administration at ISAC.

- Beginning in 2008 the assumption for future contract sales was set at 5,000 new contracts with the amount increasing by 500 per year capping at 15,000 new contracts per year. Based on historical sales, this appears to have been an unrealistic assumption.

- The fiscal year 2010 actuarial report adopted an alternative approach that amortized investment gains and losses over a five year period. This change decreased the actuarial deficit of the Program. The fiscal year 2011 actuarial report, which was done by a new actuary, reverted to the traditional method. The actuary stated that this “smoothing” method “... is not commonly used as an actuarial assumption for prepaid tuition programs but is used more readily in pension investment programs.”

Digest Exhibit One
FUNDED RATIO OF THE COLLEGE ILLINOIS PROGRAM
Fiscal Years 1999 – 2011



Note: The Value of Assets includes the present value of installment contract receivables.

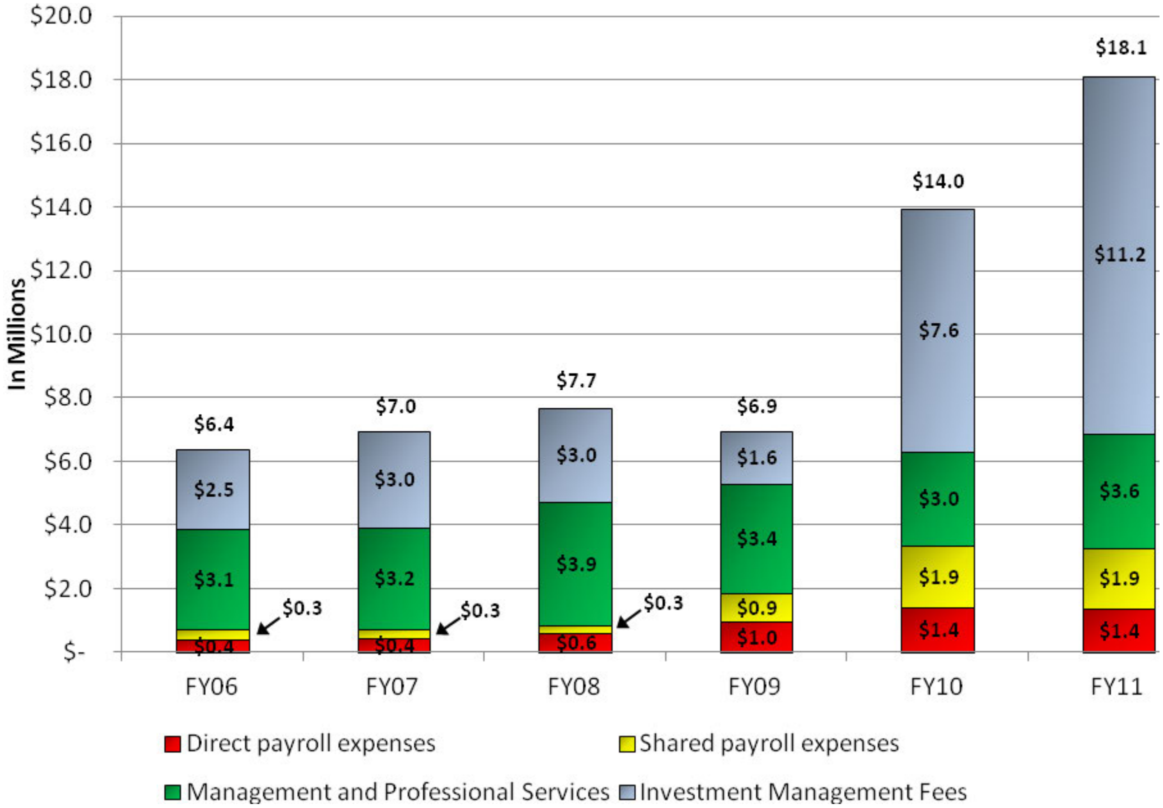
Source: OAG analysis of actuarial reports.

The Program has shown an actuarial deficit for each of the last 11 years. The actuarially determined funded ratio of the Program as of June 30, 2011 was 70.5 percent.

Digest Exhibit One shows the funded ratio of the Program since inception. The first two years of the Program showed an actuarial reserve and funded ratio greater than 100 percent. The last 11 years, however, have all shown an actuarial deficit. In fiscal year 2002, the funded ratio had gone down to 81.2 percent before rebounding to 93.3 percent in fiscal year 2007. The funded ratio fell dramatically over the next two fiscal years to a low of 67.6 percent in fiscal year 2009. The most recent actuarial report showed a funded ratio of 70.5 percent. (pages 72-81)

Contract sales have declined over the last six years from a high of 4,972 contracts in 2005-2006 to a low of 999 contracts in the most recent enrollment period. Recently, cancellations have outpaced sales with 1,523 cancellations in fiscal year 2011 and 778 cancellations during the first six months of fiscal year 2012. As of March 2012, the Program was closed to new enrollees. (pages 81-84)

Digest Exhibit Two
PROGRAM COSTS
Fiscal Years 2006 – 2011



Source: OAG analysis of College Illinois program costs.

Program Costs

The cost of operating the Program has risen dramatically over the last six years nearly tripling from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011.

As shown in Digest Exhibit Two, the cost of operating the College Illinois Program has risen dramatically over the last six years. Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011. There were several reasons for the increase in costs:

- Investment management fees have increased significantly from $2.5 million in fiscal year 2006 to $11.2 million in fiscal year 2011 because fees paid to managers of alternative investments have been substantially higher.

- Direct payroll expense more than tripled over the six year period increasing from $0.4 million in fiscal year 2006 to $1.36 million in fiscal year 2011. The primary reason direct payroll expense increased was that the number of employees working directly on the Program increased from 4 full time equivalent (FTE) employees in fiscal year 2006 to 11.5 FTE in fiscal year 2011. We questioned $613,000 in salaries and benefits for eight different employees charged as a direct payroll expense to the College Illinois Program because there was insufficient documentation to show how much, if any, of their duties pertained to the Program.

- Shared payroll expense, for ISAC employees that provide services to the Program but do not work directly for the Program, increased significantly over the six year period from $0.3 million in fiscal year 2006 to $1.9 million in fiscal year 2011. (pages 92-99)

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program.

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program. An administrative load fee was included as part of tuition contract prices. However, ISAC could not provide any information to quantify this fee and its effect on the overall pricing structure. Without further documentation, there is no assurance that ISAC is accounting properly for administrative costs when establishing tuition contract prices. (pages 86-89)

The primary control over Program costs is the passage of an annual budget by the Commission. However, even though Commission members raised questions when approving the budget, there was never a change to the proposed budget in the six years examined. Other large increases, such as a 363 percent increase in intra-agency services in fiscal year 2010, went unquestioned when approved by the Commission. Commission members were not provided information on actual expenses that they could use to compare to the approved budgeted amounts. (pages 89-90)

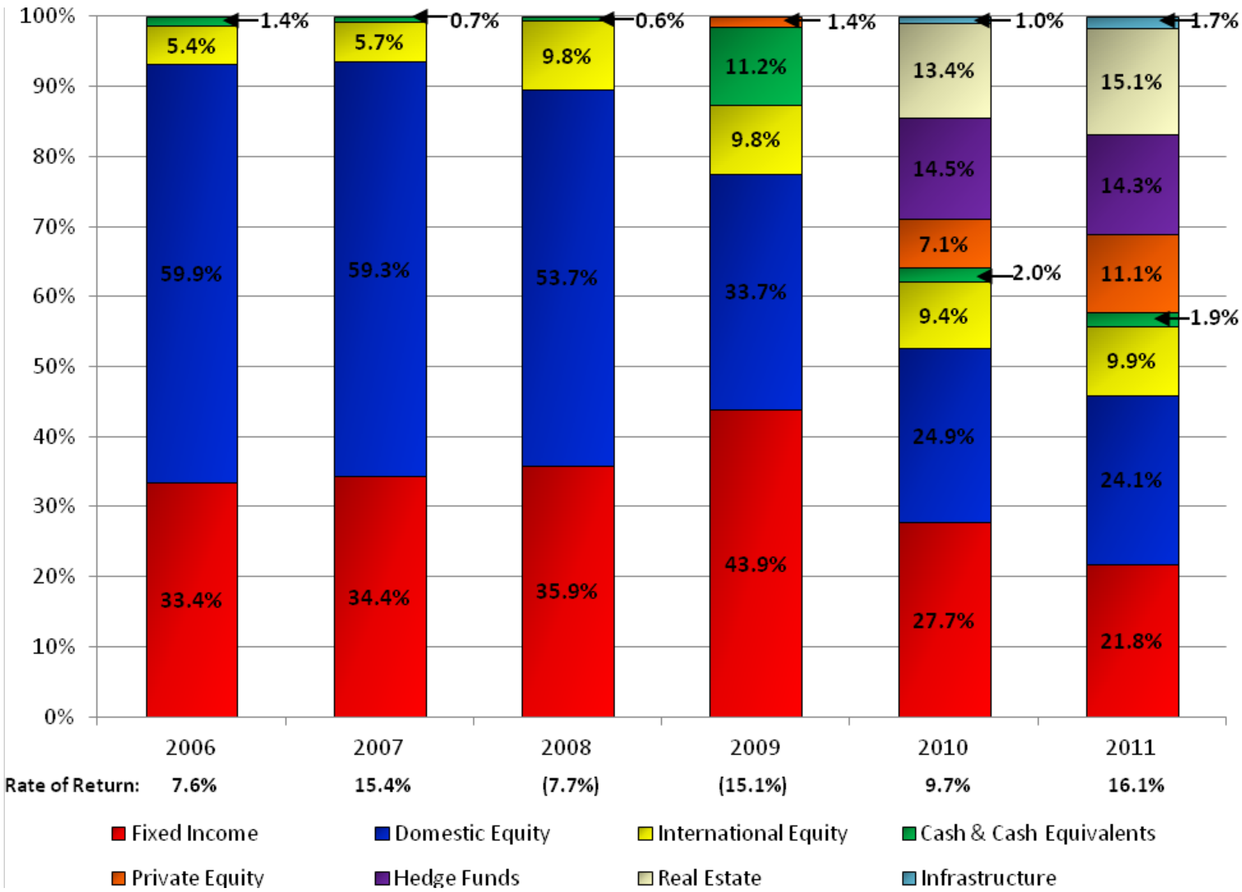
ISAC does not have a set policy for how Program costs are allocated. The method used resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts.

ISAC does not have a set policy for how Program costs are allocated. Although ISAC follows the same basic method each year, there is no policy or methodology in place to ensure that costs are allocated consistently from year to year. This resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts. This method also makes the process appear arbitrary and makes it difficult to determine the true cost of operating the program. (pages 90-92)

Asset Allocation

The College Illinois asset allocation has evolved over the last six years. In 2006, the Fund was invested entirely in traditional asset classes: fixed income, equity, and cash. Conversely, in 2011, these asset classes accounted for 58 percent of the Fund while the remaining 42 percent was invested in alternative investments: private equity, hedge funds, real estate, and infrastructure. Digest Exhibit Three shows how the asset allocation has evolved over the last six years.

Digest Exhibit Three
COLLEGE ILLINOIS ASSET ALLOCATION – PERCENTAGE ALLOCATION
FY06 – FY11



Source: OAG analysis of College Illinois investment data.

We contracted with a consultant, Ibbotson Associates, to perform an independent asset allocation study of the College Illinois current investment mix as directed by House Resolution 174. **The analysis was of the asset allocation as of June 30, 2011, and was not an analysis of the actual past performance of the portfolio.** Results of the analysis included the following:

Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments.

- Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments. Returns were lower for the shorter time periods examined but higher for the longer time periods. A forward looking analysis showed that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

- **It is important to note that the allocation study used benchmark indices for the different asset classes. The actual investments made by College Illinois and their performance may differ.** To perform the analysis, Ibbotson analyzed College Illinois' asset allocation as of June 30, 2011, and selected benchmarks to accommodate the study. Ibbotson noted that decisions made when implementing an asset allocation policy with different investment managers have the potential to significantly add or detract value by introducing manager specific risk. As an example, College Illinois recently invested $14 million in a single company. This investment involved a high degree of risk in that the company is in a relatively early stage of development with little operating history. In addition, Chapter Two notes several issues with ISAC's selection of investment managers including selecting two managers outside of the normal procurement process.

The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined.

- The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined. The state with the least risky portfolio concentrated the majority of its assets in fixed income investments. Only 1 of the other 4 states examined included alternative investments in its portfolio. This state's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois.

- The College Illinois program differentiates itself from the programs of other states by having a more diversified asset allocation policy. Both the target and actual asset allocations offer exposures to a larger number of asset classes than the portfolios of the other states. Historically, alternative asset classes such as private equity, hedge funds and infrastructure had lower correlations to the traditional asset classes. Therefore, adding these asset classes to a traditional equity and fixed income portfolio has the potential to improve a portfolio's risk and return characteristics.

- Although the overall asset allocation is well diversified as measured by the number of asset classes in the opportunity set, there is a lack of diversification within the traditional fixed income portion of the portfolio.

- In addition, while the exposure to alternative asset classes was one of the strengths of the College Illinois asset allocation, the individual weights to the alternative asset class do not seem to be optimal given the results for mean-variance optimization and they seem to be concentrated in the hedge fund asset class.

While the asset allocation study showed that a portfolio with alternative investments was less risky compared to a standardized portfolio without alternative investments, there are other issues to consider when using alternative investments. The lengths of the agreements with investment managers for alternative investments are much longer making the portfolio less liquid. Management fees were also substantially higher and additional outside costs were incurred related to legal services and due diligence services. (pages 102-116)

Marketing of the Program

The marketing materials examined made statements that could lead a purchaser to believe that an investment in College Illinois was backed by the State, was safe and secure, and transferred the risk to the State.

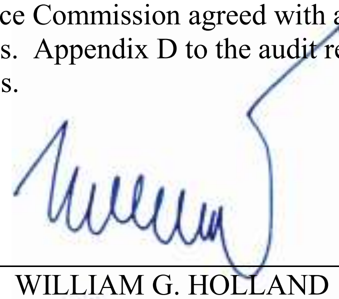
Assessing the intent of marketing materials is a difficult endeavor. There is not a set standard to measure against and the intent is thus open to different interpretations. However, **the marketing materials examined made statements that could lead a purchaser to believe that an investment in College Illinois was backed by the State, was safe and secure, and transferred the risk to the State**.

ISAC made changes to the marketing materials over the years. In 2008, ISAC removed the term "backed by the State" from its marketing materials including press releases, enrollment booklets, and the Annual Report. However, ISAC continued to promote that an investment in College Illinois was safe and secure, was not tied to the stock market, and transferred risk from the purchaser to the State.

At the same time, ISAC added language to its Master Agreement (a document included in a Program contract which describes the basic terms and conditions of the Program) to emphasize the risk involved. (pages 117-124)

RECOMMENDATIONS

The audit report contains 15 recommendations. The Illinois Student Assistance Commission agreed with all of the recommendations. Appendix D to the audit report contains ISAC's responses.



WILLIAM G. HOLLAND
Auditor General

WGH:DJB

AUDITORS ASSIGNED: This Management Audit was performed by the Office of the Auditor General's staff with assistance from Ibbotson Associates in conducting the asset allocation study.

TABLE OF CONTENTS

GLOSSARY OF TERMS

Alternative Investments – Investments in the non-traditional asset classes: hedge funds, private equity, real estate, and infrastructure.

Commission – Generally in the audit report, this refers to the 10-member Commission that oversees the Illinois Student Assistance Commission.

Efficient Frontier – An efficient frontier is the line that connects all optimal portfolios across all levels of risk. An optimal portfolio is simply the mix of assets that maximizes portfolio return at a given risk level.

Illinois Student Assistance Commission (ISAC) – The State agency that administers the College Illinois Prepaid Tuition Program.

Investment Advisory Panel – A seven-member panel, established by the Illinois Prepaid Tuition Act, which is to offer advice and counseling regarding the investments of the Illinois Prepaid Tuition Program.

Investment Committee – A committee, established in the Investment Policy, consisting of at least two members of the Commission appointed by the Chairman of the Commission, which is to provide advice and guidance to ISAC's Chief Investment Officer on issues related to the investment of Fund assets.

Investment Policy – The College Illinois Program's Statement of Investment Policy that is required to be approved on an annual basis. The Investment Policy specifies the policies to be utilized by the Commission in its administration of the Illinois Prepaid Tuition Trust Fund.

Portfolio Committee – A committee, established in the Investment Policy, which is to consist of ISAC's Executive Director, Chief Investment Officer, and Director of Portfolio Management and Direct Investment. The Portfolio Committee is to meet monthly to review the portfolio, asset allocation, and affect any rebalancing based on decisions of the Committee and acting within the guidelines of the Investment Policy.

Standard Deviation – A measure of risk that sheds light on historical volatility. The higher the standard deviation is, the more volatile the investment would be.

Chapter One

INTRODUCTION AND BACKGROUND

REPORT CONCLUSIONS

The procurement process (during the period where program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011) lacked consistency, transparency, independence, documentation, and compliance with procurement rules and the Procurement Code. In addition, the lack of implementation of the agency's conflict of interest policy led to the appearance of multiple conflicts, including multi-million dollar investments into funds where a staff member had private investments.

Although the Prepaid Tuition Fund had an annual average return of 3.5 percent from its inception in 1998, the actuarial assumed rates for 2006 to 2011 ranged from 7.5 percent to 9.25 percent. Fees collected from purchasers of tuition contracts covered only 7 percent of operating costs in fiscal year 2011. In fact, as program costs increased (from $6.4 to $18.1 million from fiscal years 2006 to 2011), the fees received actually declined (from $2.3 to $1.4 million).

Background

Established in 1997, the College Illinois! Prepaid Tuition Program (College Illinois or Program) allows participants to purchase a contract that prepays the full cost of tuition and mandatory fees at Illinois public universities and Illinois community colleges. The Illinois Student Assistance Commission (ISAC) administers the Program. ISAC's duties include investing Program funds with investment managers. The funded ratio of the Program has declined from 93.3 percent in 2007 to 70.5 percent in the most recent actuarial report which is as of June 30, 2011. House Resolution Number 174 directed the Auditor General to conduct a management audit of the Program.

Investing College Illinois Funds

The Illinois Student Assistance Commission circumvented the Illinois Procurement Code by selecting two investment managers (Kennedy Wilson and Lyrical-Antheus Realty Partners) outside of the normal procurement process. As discussed below, **it was later discovered that the former Director of Portfolio Management had become a limited partner in one of the investments**. During fiscal year 2011, these two investment managers received more than $2.6 million in investment fees.

The procurement process was also circumvented when awarding a contract to Mesirow Financial Investment Management (Mesirow) to perform due diligence services on the two investment managers. The fee structure for the due diligence services may have created an incentive for Mesirow to recommend the investments. Mesirow completed the first due diligence review prior to a contract to perform the work being in place.

ISAC did not comply with its own conflict of interest policy. A conflict of interest requirement contained in the Program's Investment Policy, which required an annual conflict of interest attestation by Commissioners and employees authorized to make investment decisions, was never implemented. We noted potential conflict of interest issues which included the following:

- There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. Both involved investment firms that were selected as investment managers, one of which received $20 million in funding.

- **In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager, Balestra Capital, while the selection process involving that investment manager was still ongoing –** specifically, a family partnership in which the Director of Portfolio Management had an economic interest made a $500,000 investment in Balestra Capital. He was also a member of the evaluation team that selected Balestra Capital.

- In another potential conflict of interest, the former Director of Portfolio Management introduced an investment with Lyrical-Antheus Reality Partners to ISAC and then, after leaving ISAC, became a limited partner in the investment.

In examining investment manager files, we noted one investment manager, Reynoso Asset Management, was provided funding that exceeded the amount authorized by $10 million. We also noted that a private equity investment of $14 million was made with a single company, Fisker Automotive, despite several risks outlined in the Subscription Agreement.

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments. The selection of investment managers changed in several distinct ways:

- The makeup of the evaluation committee changed over the time period examined. The evaluation committee was more diversified in the earlier procurements including a Commissioner and a member of the Advisory Panel, in addition to staff at ISAC. Later procurements included only ISAC staff on the evaluation committee. Despite ISAC's State Purchasing Officer previously advising against it, the Executive Director of ISAC was included on the evaluation committee for three procurements. Participating on the evaluation team could allow the Executive Director to assert undue influence over the process.
- For earlier procurements, Marquette Associates, the Program's Investment Consultant, assisted in evaluating proposals but was removed from this role in later procurements. It is unclear why ISAC removed the Investment Consultant from the process. One effect was creating greater control for the now smaller evaluation teams, consisting solely of ISAC staff, over the selection process.

- The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session. By moving these discussions to closed session, ISAC removed transparency from the process.

We reviewed all 14 procurements involving the selection of investment managers during fiscal years 2006 through 2011. We noted several issues with the procurements:

- For the interviews/presentations of the finalists, none of the 14 procurements examined contained documentation on who attended or what was discussed.

- The procurement files lacked evidence of discussions regarding the rationale for the number of proposers selected for award. The number of winning vendors ranged from 1 to 13. The justification and rationale for the number selected was unclear.

- The procurement files were incomplete. Three of the 14 procurements lacked documentation on the initial scoring of the proposers and 1 of 14 lacked final scoring. Many evaluation forms lacked notes to justify the scores given.

- We noted mistakes during the scoring process for 4 of the 14 procurements. Some of these errors impacted the firms selected.

- For 3 of the 14 procurements, the evaluation criteria were changed to total only 450 points instead of the 500 points outlined in the Request for Proposals.

The Investment Advisory Panel (Panel), established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission. The Commission members approve all investment decisions and may lack the expertise that members of the Panel possess. Specifically, the Panel raised concerns over changing the Investment Policy to allow direct private equity investment. While the Panel raised concerns to the senior staff at ISAC, if those concerns are not, in turn, communicated to the Commission, the purpose of the Panel is negated.

In addition, the Panel failed to fulfill its statutory duties by not meeting at least twice annually as required by the Illinois Prepaid Tuition Act. The Panel also did not meet publicly with the Commission at least once annually to discuss issues and concerns relating to the Illinois Prepaid Tuition Program. There was also at least one vacancy on the seven-member Panel throughout the audit period.

The College Illinois Program had several other weaknesses in its internal controls over the investment process. These included:

- The Commission has not approved a new Investment Policy since January 2010 which violates the statutory requirement of annually adopting a comprehensive investment plan.

- The Portfolio Committee, which took over the rebalancing function from the independent Investment Consultant, failed to meet monthly as required in the Investment Policy and had not met since October 2010.

- The Investment Committee, which was to consist of at least two Commission members, was not formally established.

Other Issues with Program Administration

The number of employees working for the College Illinois Program increased significantly over the six year period. Twelve of the 20 employees hired during that time period were principal administrative appointments which are positions hired at the discretion of the Executive Director. Two of the positions created were investment positions for which it was not clear what duties and responsibilities were performed. Both of these positions have subsequently been eliminated.

Other testing results showed that 46 percent (11 of 24) of the employees tested lacked position descriptions that listed the education and experience needed for the positions making it impossible to determine if employees were qualified. Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated.

One employee, the Director of Portfolio Management, voluntarily resigned his position effective July 21, 2010. Five days later, on July 26, 2010, the Executive Director of ISAC signed a voluntary separation agreement with the Director of Portfolio Management that included a lump sum payment of $24,166.

The annual report, which includes the actuarial report, is one of the primary vehicles for presenting meaningful information on the College Illinois Program. While the reports contain the minimal required statutory information, they do not contain further information required by the Investment Policy. The reports also do not contain certain information that would be useful to contract holders and others who are evaluating the Program.

ISAC is responsible for the actuarial assumptions used in both the actuarial report and to set tuition contract prices. **ISAC, however, was unable to provide documentation for how certain assumptions were established or any rationale to support the assumptions used.**

- The investment return assumption of 9.25 percent, which was used in the fiscal year 2010 report, was lowered to 7.50 percent in the fiscal year 2011 report. The lowering of the investment assumption coincided with the change in administration at ISAC.

- Beginning in 2008 the assumption for future contract sales was set at 5,000 new contracts with the amount increasing by 500 per year capping at 15,000 new contracts per year. Based on historical sales, this appears to have been an unrealistic assumption.

- The fiscal year 2010 actuarial report adopted an alternative approach that amortized investment gains and losses over a five year period. This change decreased the actuarial deficit of the Program. The fiscal year 2011 actuarial report, which was done by a new actuary, reverted to the traditional method. The actuary stated that this “smoothing” method “... is not commonly used as an actuarial assumption for prepaid tuition programs but is used more readily in pension investment programs.”

The first two years of the Program showed an actuarial reserve and funded ratio greater than 100 percent. The last 11 years, however, have all shown an actuarial deficit. In fiscal year 2002, the funded ratio had gone down to 81.2 percent before rebounding to 93.3 percent in fiscal year 2007. The funded ratio fell dramatically over the next two fiscal years to a low of 67.6 percent in fiscal year 2009. The most recent actuarial report showed a funded ratio of 70.5 percent.

Contract sales have declined over the last six years from a high of 4,972 contracts in 2005-2006 to a low of 999 contracts in the most recent enrollment period. Recently, cancellations have outpaced sales with 1,523 cancellations in fiscal year 2011 and 778 cancellations during the first six months of fiscal year 2012. As of March 2012, the Program was closed to new enrollees.

Program Costs

The cost of operating the College Illinois Program has risen dramatically over the last six years. Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011. There were several reasons for the increase in costs:

- Investment management fees have increased significantly from $2.5 million in fiscal year 2006 to $11.2 million in fiscal year 2011 because fees paid to managers of alternative investments have been substantially higher.

- Direct payroll expense more than tripled over the six year period increasing from $0.4 million in fiscal year 2006 to $1.36 million in fiscal year 2011. The primary reason direct payroll expense increased was that the number of employees working directly on the Program increased from 4 full time equivalent (FTE) employees in fiscal year 2006 to 11.5 FTE in fiscal year 2011. We questioned $613,000 in salaries and benefits for eight different employees charged as a direct payroll expense to the College Illinois Program because there was insufficient documentation to show how much, if any, of their duties pertained to the Program.

- Shared payroll expense, for ISAC employees that provide services to the Program but do not work directly for the Program, increased significantly over the six year period from $0.3 million in fiscal year 2006 to $1.9 million in fiscal year 2011.

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program. An administrative load fee was included as part of tuition contract prices. However, ISAC could not provide any information to quantify this fee and its effect on the overall pricing structure. Without further documentation, there is no assurance that ISAC is accounting properly for administrative costs when establishing tuition contract prices.

The primary control over Program costs is the passage of an annual budget by the Commission. However, even though Commission members raised questions when approving the budget, there was never a change to the proposed budget in the six years examined. Other large increases, such as a 363 percent increase in intra-agency services in fiscal year 2010, went unquestioned when approved by the Commission. Commission members were not provided information on actual expenses that they could use to compare to the approved budgeted amounts.

ISAC does not have a set policy for how Program costs are allocated. Although ISAC follows the same basic method each year, there is no policy or methodology in place to ensure that costs are allocated consistently from year to year. This resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts. This method also makes the process appear arbitrary and makes it difficult to determine the true cost of operating the program.

Asset Allocation

The College Illinois asset allocation has evolved over the last six years. In 2006, the Fund was invested entirely in traditional asset classes: fixed income, equity, and cash. Conversely, in 2011, these asset classes accounted for 58 percent of the Fund while the remaining 42 percent was invested in alternative investments: private equity, hedge funds, real estate, and infrastructure.

We contracted with a consultant, Ibbotson Associates, to perform an independent asset allocation study of the College Illinois current investment mix as directed by House Resolution 174. **The analysis was of the asset allocation as of June 30, 2011, and was not an analysis of the actual past performance of the portfolio.** Results of the analysis included the following:

- Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments. Returns were lower for the shorter time periods examined but higher for the longer time periods. A forward looking analysis showed that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

- **It is important to note that the allocation study used benchmark indices for the different asset classes. The actual investments made by College Illinois and their performance may differ.** To perform the analysis, Ibbotson analyzed College Illinois' asset allocation as of June 30, 2011, and selected benchmarks to accommodate the study. Ibbotson noted that decisions made when implementing an asset allocation policy with different investment managers have the potential to significantly add or detract value by introducing manager specific risk. As an example, College Illinois recently invested $14 million in a single company. This investment involved a high degree of risk in that the company is in a relatively early stage of development with little operating history. In addition, Chapter Two notes several issues with ISAC's selection of investment managers including selecting two managers outside of the normal procurement process.

- The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined. The state with the least risky portfolio concentrated the majority of its assets in fixed income investments. Only 1 of the other 4 states examined included alternative investments in its portfolio. This state's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois.

- The College Illinois Program differentiates itself from the programs of other states by having a more diversified asset allocation policy. Both the target and actual asset allocations offer exposures to a larger number of asset classes than the portfolios of the other states. Historically, alternative asset classes such as private equity, hedge funds and infrastructure had lower correlations to the traditional asset classes. Therefore, adding these asset classes to a traditional equity and fixed income portfolio has the potential to improve a portfolio's risk and return characteristics.

- Although the overall asset allocation is well diversified as measured by the number of asset classes in the opportunity set, there is a lack of diversification within the traditional fixed income portion of the portfolio.

- In addition, while the exposure to alternative asset classes was one of the strengths of the College Illinois asset allocation, the individual weights to the alternative asset class do not seem to be optimal given the results for mean-variance optimization and they seem to be concentrated in the hedge fund asset class.

While the asset allocation study showed that a portfolio with alternative investments was less risky compared to a standardized portfolio without alternative investments, there are other issues to consider when using alternative investments. The lengths of the agreements with investment managers for alternative investments are much longer making the portfolio less liquid. Management fees were also substantially higher and additional outside costs were incurred related to legal services and due diligence services.

Marketing of the Program

Assessing the intent of marketing materials is a difficult endeavor. There is not a set standard to measure against and the intent is thus open to different interpretations. However, **the marketing materials examined made statements that could lead a purchaser to believe that an investment in College Illinois was backed by the State, was safe and secure, and transferred the risk to the State**.

ISAC made changes to the marketing materials over the years. In 2008, ISAC removed the term "backed by the State" from its marketing materials including press releases, enrollment booklets, and the Annual Report. However, ISAC continued to promote that an investment in College Illinois was safe and secure, was not tied to the stock market, and transferred risk from the purchaser to the State.

At the same time, ISAC added language to its Master Agreement (a document included in a Program contract which describes the basic terms and conditions of the Program) to emphasize the risk involved.

INTRODUCTION

On April 14, 2011, the Illinois House of Representatives adopted House Resolution Number 174 which directed the Auditor General to conduct a management audit of the College Illinois! Prepaid Tuition Program's administrative operations. (See Appendix A.) Specifically, the Resolution asked us to examine:

- The growth in recent years of program costs; and
- The efficacy of the Program's administration, and, in particular, the Illinois Student Assistance Commission's oversight and administrative capacity to evaluate and direct College! Illinois Prepaid Tuition Program investments.

The Resolution also asked us to conduct an independent asset allocation study of College Illinois! Prepaid Tuition Program investments to determine the overall level of risk associated with the Program's current alternative investment mix; it is intended that this study shall be conducted in comparison with a standardized investment portfolio containing no alternative investments, as well as in comparison with actual investment portfolios of similar public prepaid tuition programs currently operating in the states of Michigan, Virginia, Washington, and Florida.

BACKGROUND

In 1997, the Illinois Prepaid Tuition Act was passed which created the Illinois prepaid tuition program. The intent of the Act is to encourage and better enable Illinois families to help themselves finance the cost of higher education, specifically through a program that provides Illinois families with a method of State tax-free and federally tax-exempt savings for higher education.

The College Illinois! Prepaid Tuition Program (College Illinois or Program) is administered by the Illinois Student Assistance Commission (ISAC). College Illinois allows participants to purchase a contract that prepays the full cost of tuition and mandatory fees at Illinois public universities and Illinois community colleges.

The Illinois Prepaid Tuition Act contains many requirements which we examined and will be discussed in various sections in the report. These include:

- Establishment of an Investment Advisory Panel;
- Adopting a comprehensive investment plan;
- Completing an annual report; and
- Establishing fees to cover administrative costs.

TIMELINE OF THE COLLEGE ILLINOIS PROGRAM

A number of events have occurred relating to the College Illinois Program. House Resolution 174 raised questions about the Program's investments noting that investments had moved from stocks and bonds to a significant portion of alternative investments. It also noted that the funded status of the Program had deteriorated. The Resolution stated that the Program is not backed by the full faith and credit of the State of Illinois but rather constitutes a moral obligation of the State making the Program's long-term investment portfolio vulnerable to risk-intensive investment practices.

Exhibit 1-1 presents a timeline that highlights key events many of which are discussed later in the report.

PROGRAM INFORMATION

College Illinois offered plans for public university semesters, community college semesters, and a combined plan that included two years at a community college and two years at a public university. Plans could be purchased one semester at a time or up to a maximum of nine semesters for any one future student. Benefits may also be used at private colleges within Illinois and at public universities and private colleges and universities across the country as well.

For the 2005-2006 enrollment period, College Illinois had a set enrollment period that lasted from October 31 to April 3. The pricing schedule was the same for the entire enrollment period. Three basic types of plans were offered:

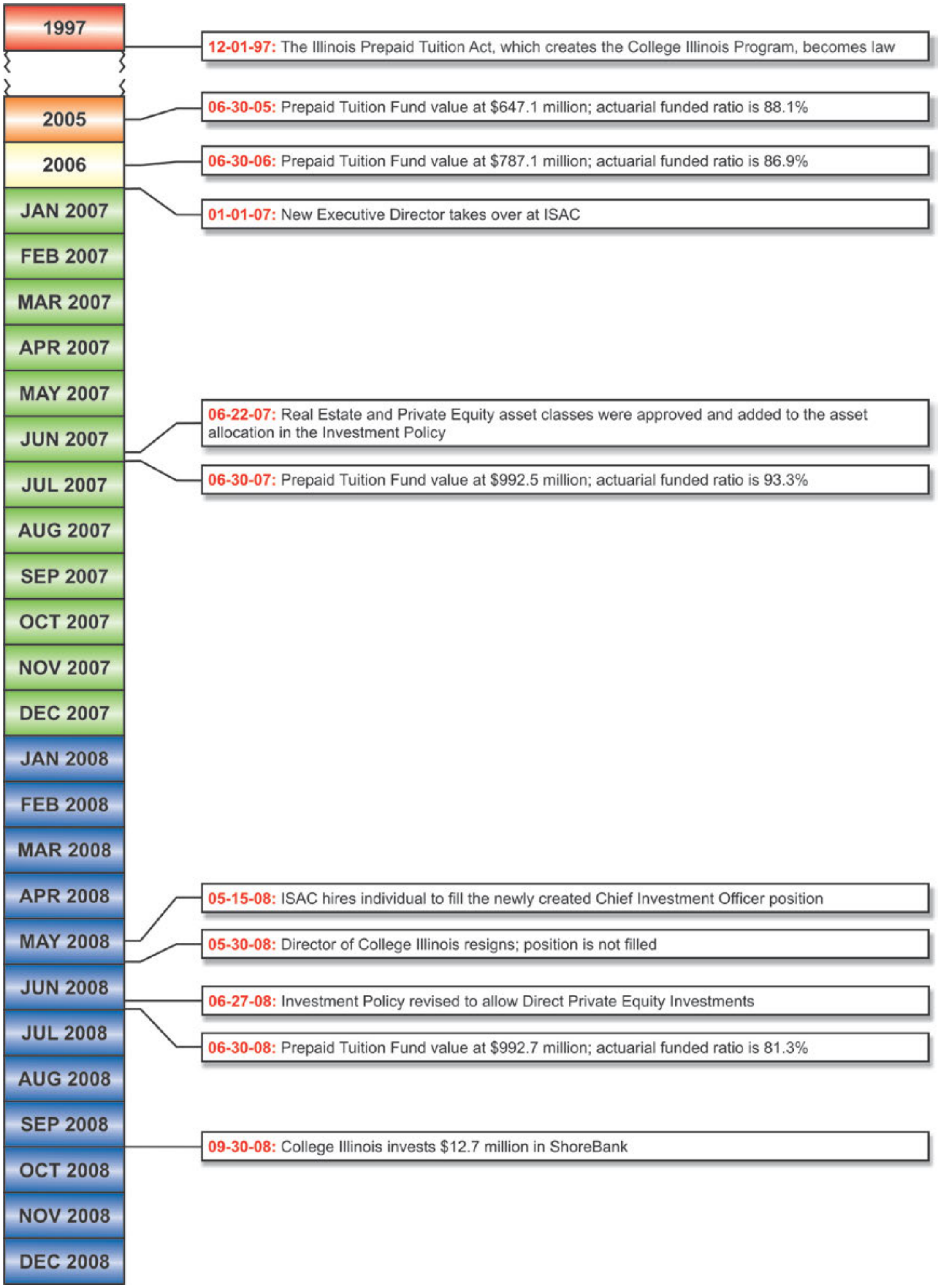
- University Plan – This plan covers tuition and mandatory fees at every Illinois public university. The plan could be purchased in semester increments with a maximum of nine semesters purchased.

- Community College Plan – This plan covers tuition and mandatory fees at community colleges throughout the State. This plan could also be purchased in semester increments with a maximum of four semesters purchased.

- Combination Plan – This plan is a combination of the two plans. It could only be purchased for a set amount of eight semesters – four community college semesters and four university semesters.

Different payment options were also available. Semesters could be purchased in a lump sum payment, an annual payment for either 5 or 10 years, and monthly payments over either 5 or 10 years.

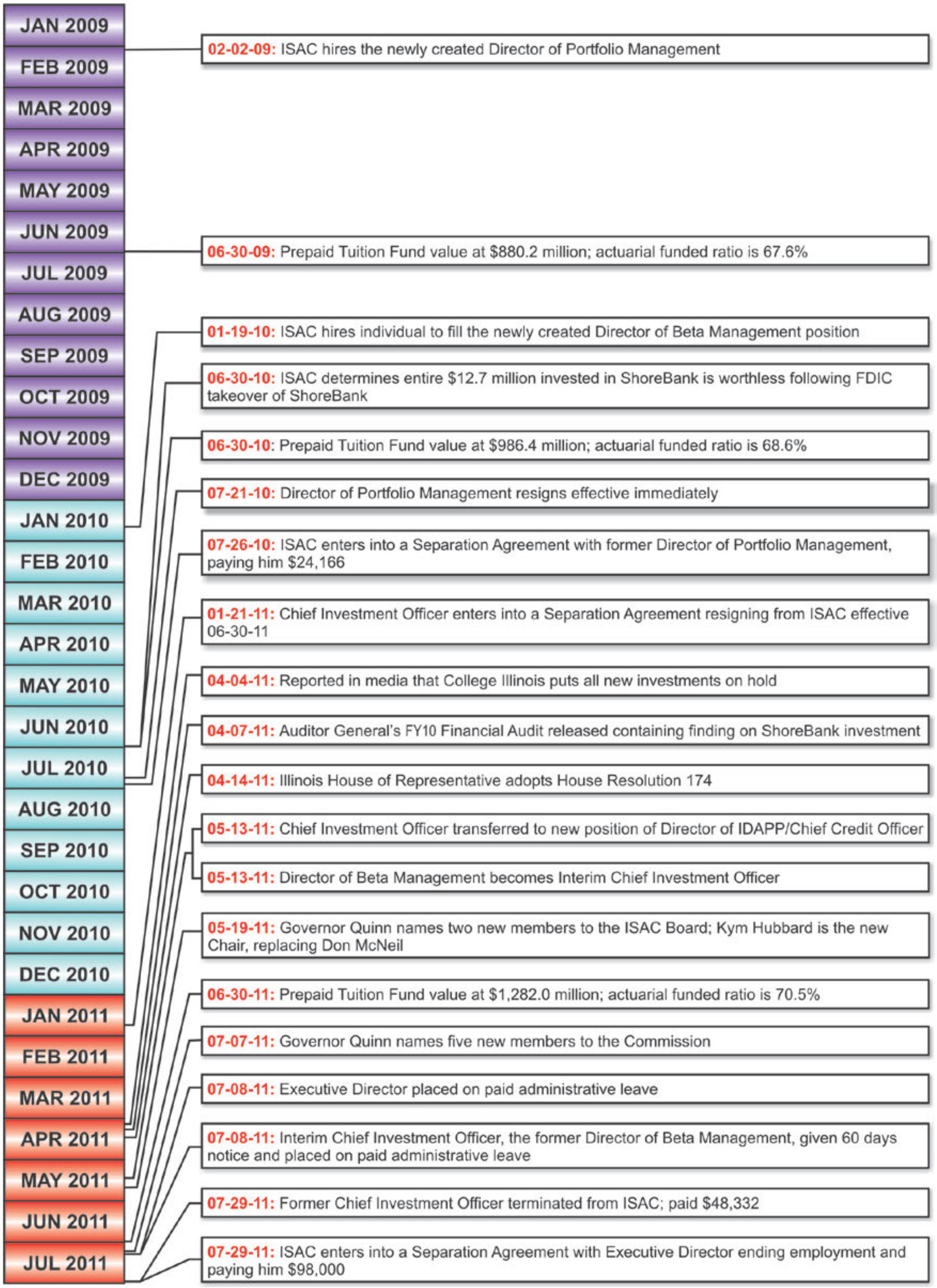
Exhibit 1-1
COLLEGE ILLINOIS TIMELINE OF EVENTS



Source: OAG analysis of various documents.

Exhibit 1-1

COLLEGE ILLINOIS TIMELINE OF EVENTS (Continued)



Source: OAG analysis of various documents.

Beginning with the 2008-2009 enrollment period, the University option was changed to two different options. One option, called University Plus, was for semesters at only the University of Illinois at Urbana-Champaign. The other option was for semesters at all of the other public universities. The University Plus option was markedly more expensive than the other option.

Beginning in 2009, the enrollment period was changed to a year-round enrollment. One big difference was that the plans became more expensive as the enrollment period progressed. Prices were set for each month of the enrollment period beginning November 1, 2009, and ending October 31, 2010, with the price escalating each month. The Program is currently closed to new enrollees.

ORGANIZATIONAL STRUCTURE

The Illinois Student Assistance Commission is overseen by a 10-member commission (Commission) appointed by the Governor. The current Commission consists of 8 members with 2 vacancies. (See Exhibit 1-2.) In May 2011, Governor Quinn replaced the Chairperson, Don McNeil, who had been appointed as Chair of the Commission in 2005, with Kym Hubbard. The current 8 members are all newly appointed since May 2011.

Exhibit 1-2
MEMBERS OF THE COMMISSION
As of March 2012

Member	Profession	Year Appointed
Kym Hubbard (Chair)	Treasurer and Chief Investment Officer, Ernst & Young, LLP	2011
Miguel Del Valle (Vice Chair)	Former Chicago City Clerk, former State Senator	2011
Mark Donovan	Vice Chancellor of Administrative Services, University of Illinois at Chicago	2011
Kendall Griffin	Assistant Principal for Operations, Niles West High School	2011
Kevin Huber	Executive Director and Chief Investment Officer, Chicago Teachers' Pension and Retirement Fund	2012
Verett Ann Mims	Assistant Treasurer, Global Treasury Operations, Boeing	2011
Paul Roberts	Associate Provost, Enrollment Management, Loyola University Chicago	2011
Kim Savage	Retired; Student Affairs Assessment Program Coordinator, Assistant to Vice Chancellor, University of Illinois at Chicago	2011

Source: ISAC website.

To obtain an overview of operations, we established an audit period of six years encompassing fiscal years 2006 through 2011. Exhibit 1-3 shows members of the Commission that served during the majority of the audit period. A number of new members were appointed in November 2005. There were five members who were replaced at that time. Those five members are not listed in Exhibit 1-3 as they only participated in one meeting at the very beginning of the audit period. Andrew Davis served for less than a year as a Commission member before leaving to become Executive Director of ISAC. He took over as Executive Director in January 2007.

Exhibit 1-3
PAST MEMBERS OF THE COMMISSION
Served during the Audit Period

Member	Profession (when appointed)	Date Appointed	Tenure Ended
Hugh Van Voorst	Director of Aeronautics, Illinois Department of Transportation	06-2002	07-2011
Robert Casey	Partner, Casey Brannen & Romag	01-2003	09-2006
Mary Ann Louderback	Former Member, Illinois Educational Labor Relations Board	01-2003	07-2011
Donald McNeil (Chair)	Partner, Barnes & Thornburg LLP	11-2005	05-2011
Sharon Alpi	Coleman Foundation Professor in Entrepreneurship, Tabor School of Business, Millikin University	11-2005	07-2011
Dr. Lynda Andre	Assistant Superintendent of Curriculum, Edwardsville School District	11-2005	07-2011
Andrew Davis	Securities Trader, Pinnipedia LLC	11-2005	09-2006
Warren Daniels Jr.	Managing Director, Loop Capital Markets LLC, of Chicago	11-2005	05-2009
David Vaught	Attorney and Financial Advisor, Mitchell, Vaught and Taylor, Inc.	11-2005	01-2009
Sean Dauber	Vice President of Marketing and New Business Development, The Horton Group	06- 2008	07-2011
Ashley Dearborn	Student Member	11-2005	06-2007
Kelvin Wing	Student Member	01-2008	06-2009
Johnathan Wilson	Student Member	09-2009	02-2011

Source: OAG analysis of annual reports and Commission meeting minutes.

The Commission is to perform a number of roles related to College Illinois including:

- **Setting contract prices and fees for the next enrollment period –** ISAC staff, in conjunction with the Program's actuary, develops the pricing schedules. The proposed pricing schedule, along with the underlying assumptions and methods, are presented to the Commission. The Commission then votes to approve the pricing schedule.

- **Selection of investment managers –** Investment managers are generally selected through a procurement process. Once the process is complete, one or more managers are recommended to the Commission which then approves the selection. In addition, beginning in September 2009, the Commission began approving resolutions to authorize entering into investment agreements with previously selected managers. These resolutions specified the managers and the amounts to be invested.

- **Approval of Investment Policy –** Revisions are made to the Statement of Investment Policy. These revisions can be to a number of different areas in the policy and can come from a number of different sources including staff, the investment consultant, and Commission members.

- **Approval of Budget –** Each year, the Commission is presented with and approves the budget request for the College Illinois Program.

- **Appointment of Investment Advisory Panel members –** The Commission approves the nominations of new members to the Panel. The Commission also approves reappointments of members whose terms have expired.

- **Approval of other contracts –** Other vendors, such as the investment consultant, records administrator, and marketing agent are selected through a procurement process. The Commission approves the selection and authorizes staff to enter into contractual agreements with the vendors.

ISAC Staff

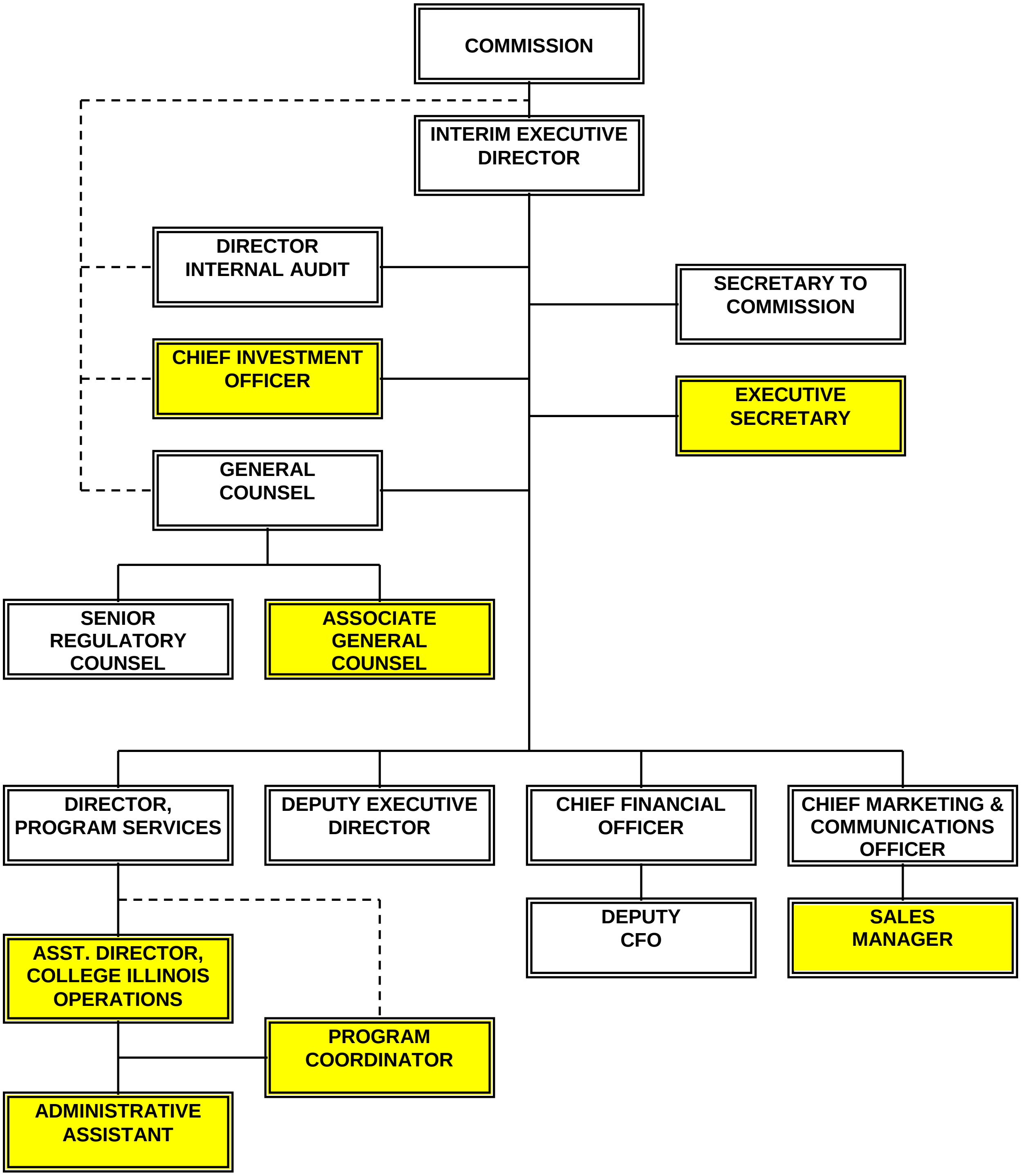
While the Commission oversees the College Illinois Program, ISAC staff control the day to day operations of the Program. Exhibit 1-4 shows the organizational structure of ISAC as of August 2011. Positions that work directly on College Illinois are highlighted in yellow. After personnel changes in July 2011, the number of employees who worked directly on the College Illinois Program was seven.

As can be seen in the exhibit, College Illinois employees are located in different organizational units at ISAC and there is not currently a position of Director of the College Illinois Program. This was not always the case. For this audit, we examined fiscal years 2006 through 2011. In 2006, there were four employees that worked on the Program. This included the Director of College Illinois and three employees that reported to him. The number of employees gradually increased. In 2008, the Director of the Program resigned and the position was not filled. Instead, a new position of Chief Investment Officer was created. However, as shown in Exhibit 1-4, none of the other College Illinois employees report to the Chief Investment Officer.

One effect of this reorganization was to give more control of the Program to the Executive Director of ISAC. Other changes that were made to give the Executive Director more control over the Program will be discussed in Chapter Two. Another effect of the reorganization was a lack of cohesiveness. Having positions in different areas, all reporting to different people, results in a lack of cohesiveness and accountability that could have an effect on the efficient operation of the Program.

Exhibit 1-4

ORGANIZATIONAL CHART FOR ISAC AND COLLEGE ILLINOIS – AS OF AUGUST 1, 2011



Note: Employees highlighted in yellow work primarily on College Illinois.

Source: OAG analysis of ISAC organizational chart.

EXAMINING THE ORGANIZATIONAL STRUCTURE	
RECOMMENDATION NUMBER 1	***The Illinois Student Assistance Commission should examine the current organizational structure of the College Illinois Program and implement changes to make operations more cohesive and to enhance accountability.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. Beginning with the appointment of the new Commission Board in July 2011, ISAC has begun to review and revise its organizational structure. The first step in this reorganization was hiring a new Chief Investment Officer and a new Executive Director, who began working in December 2011 and February 2012, respectively. As part of his new duties, the Executive Director is reviewing the College Illinois! organizational structure in keeping with this recommendation and will make any necessary changes to ensure operations are more cohesive and to increase accountability.

PREPAID TUITION PROGRAMS IN OTHER STATES

According to the College Savings Plans Network (CSPN), there are 11 states that have prepaid tuition plans that are currently open for new enrollees. In 1991, CSPN was formed as an affiliate to the National Association of State Treasurers. Established to make higher education more attainable, CSPN serves as a clearinghouse for information among state-administered college savings programs.

Exhibit 1-5 lists the states with active prepaid tuition plans and compares them to College Illinois. The exhibit lists the number of open accounts and the value of the assets under management as of June 30, 2011. This information was taken from the CSPN website. The Audit Resolution asked us to compare the College Illinois portfolio to portfolios in the states of Florida, Michigan, Virginia, and Washington (see Chapter Five).

Other states, such as Alabama, Kentucky, and Tennessee, had prepaid programs that have either been permanently closed or are no longer taking new enrollees. Texas first began a program in 1996. It was closed to new enrollment in June 2003 when tuition prices were deregulated allowing universities to increase tuition at their discretion. The Texas Tuition Promise Fund, the state's new prepaid tuition plan, opened for enrollment in 2008. The old plan was backed by the full faith and credit of the state of Texas but the new plan is not. The new plan allows participants to purchase tuition units at today's college prices that can be redeemed in the future for tuition and required fees. Texas public colleges and universities must accept the tuition units as payment for tuition and required fees; however, contracts used for Texas private or out-of-state schools are subject to investment risk.

Exhibit 1-5
OTHER STATES' PREPAID TUITION PROGRAMS

State	Plan Name	Assets Under Management[1]	Open Accounts[1]
Illinois	College Illinois! Prepaid Tuition Program	$1,119,787,291	59,736
Alaska[2]	University of Alaska College Savings Plan	$276,194,237	25,327
Florida	Florida Prepaid College Plan	$8,519,622,956	586,550
Maryland	Maryland Prepaid College Trust	$658,167,358	28,728
Massachusetts	The U.Plan Prepaid Tuition Program	$82,346,944	13,882
Michigan	Michigan Education Trust	$906,853,871	49,834
Mississippi	Mississippi Prepaid Affordable College Tuition Program	$245,952,932	25,088
Nevada	Nevada Prepaid Tuition Program	$130,800,000	9,955
Pennsylvania	Pennsylvania 529 Guaranteed Savings Plan	$1,372,000,000	94,858
Texas	Texas Tuition Promise Fund	$228,437,645	20,059
Virginia	Virginia Prepaid Education Program	$1,924,977,504	70,836
Washington	Guaranteed Education Tuition	$1,901,564,092	115,983

[1]As of June 30, 2011, as reported on the College Savings Plan Network website.

[2]Alaska's plan has different options one of which allows a purchaser to lock in tuition at the University of Alaska. Reported numbers are for the plan as a whole.

Source: College Savings Plans Network.

Administration of the Other States' Programs

As noted previously, the College Illinois Program is administered by the Illinois Student Assistance Commission. In most other states, prepaid tuition programs are administered by entities that either specialize in investing assets or were specially created to run the programs.

Exhibit 1-6 shows the 11 states with active prepaid tuition programs. The exhibit shows who administers the programs and where those entities are located within state government. Many of the entities shown appear to have managing investments as one of their core responsibilities:

- In five states (Michigan, Mississippi, Nevada, Pennsylvania, and Texas), the plans are housed within either the State Treasurer or State Comptroller whose primary duties include investing state funds.
- Similarly, one state (Florida) is housed with the State Board of Administration which is primarily an asset management organization responsible for investing state assets.
- Two states (Maryland and Virginia) have specially created agencies whose primary duties are to oversee the college savings plans.
- One state (Washington) is administered by a higher education entity; however, the investments are overseen by the Washington State Investment Board.
- One entity, the Massachusetts Educational Financing Authority, appears similar to ISAC.

Exhibit 1-6
ADMINISTRATORS OF OTHER STATES' PROGRAMS

State	Administered by:	Housed within:
Illinois	***Illinois Student Assistance Commission*** • Agency created in 1957 whose mission is to make college accessible and affordable for Illinois students.	***Independent Agency***
Alaska	***Education Trust of Alaska*** • Offers three 529 college savings plans	***University of Alaska*** • Board of Regents serves as Trustee
Florida	***Florida Prepaid College Board*** • Specially created Board that oversees two college investment plans.	***The State Board of Administration*** • Primarily an asset management organization responsible for investing state and local government assets.
Maryland	***College Savings Plans of Maryland*** • Independent agency created to oversee two college investment plans • 10-member board, chaired by the Treasurer of the State of Maryland	***Independent Agency***
Massachusetts	***Massachusetts Educational Financing Authority*** • Specially created authority created to make higher education more accessible and affordable	***Independent Agency*** • Not-for-profit self-financing state authority
Michigan	***Michigan Education Trust*** • Specially created Board that administers the prepaid program • Nine-member board, chaired by the State Treasurer	***State of Michigan Department of Treasury*** • Collects, invests, and disburses all State monies
Mississippi	***Office of the State Treasurer, College Savings Division*** • Nine-member Board • Oversees two college savings programs	***Office of the State Treasurer*** • Responsible for receiving, disbursing and investing State funds
Nevada	***Office of the State Treasurer*** • Under the direction of the Board of Trustees of the College Savings Plans of Nevada (five-member Board)	***Office of the State Treasurer*** • Duties include establishing and operating investment programs for all available State funds
Pennsylvania	***Pennsylvania Treasury, Tuition Account Program Bureau*** • Oversees two college investment plans	***Pennsylvania Treasury*** • Investment management is overseen by Treasury and its investment advisors and asset managers
Texas	***Texas Prepaid Higher Education Tuition Board*** • Oversees several college savings plans • Seven-member Board chaired by Texas Comptroller of Public Accounts	***Office of the Comptroller of Public Accounts*** • Acts as tax collector, chief accountant, chief revenue estimator and chief treasurer for all of state government
Virginia	***Virginia College Savings Plan*** • Independent agency created to oversee four college savings plans	***Independent Agency***
Washington	***Washington Higher Education Coordinating Board*** • Five-member Guaranteed Education Tuition Committee provides oversight	***Independent Agency*** • However, the Washington State Investment Board oversees investments

Source: OAG analysis of other states' programs.

OTHER ILLINOIS ENTITIES

In Illinois, a number of other entities invest funds. These include:

- The Illinois State Board of Investment;
- The State Universities Retirement System; and
- The Teachers' Retirement System;

Exhibit 1-7 compares annualized investment returns for these other entities to College Illinois.

Exhibit 1-7
ANNUALIZED INVESTMENT RETURNS AT OTHER ILLINOIS ENTITIES

Agency	Market Value of Assets – as of June 30, 2011 – (in billions)	Annualized Return – Net of Fees –		
		3 year	5 year	10 year
ISAC – College Illinois	$1.1	2.6%	2.9%	3.5%[1]
Illinois State Board of Investment	$11.5	2.0%	3.1%	4.5%
State Universities Retirement System	$14.3	4.6%	5.3%	6.1%
Teachers' Retirement System	$37.7	2.6%	4.1%	6.0%

[1]College Illinois 10 year return was not available so return since inception in 1998 is shown.

Source: Agency annual reports and investment reports.

AUDIT SCOPE AND METHODOLOGY

We conducted this performance audit in accordance with generally accepted government auditing standards and the audit standards promulgated by the Office of the Auditor General at 74 Ill. Adm. Code 420.310. 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.

The audit objectives for this audit were those as delineated in House Resolution Number 174 (see Appendix A), which directed the Auditor General to conduct a management audit of the College Illinois! Prepaid Tuition Program's administrative operations. The audit objectives are listed in the Introduction section of this chapter. Fieldwork for this audit was conducted from November 2011 to January 2012.

In conducting the audit, we reviewed applicable State statutes and rules. We reviewed compliance with those laws and rules to the extent necessary to meet the audit's objectives. Any instances of non-compliance we identified are noted in this report. We also reviewed management controls and assessed risk related to the audit's objectives. A risk assessment was conducted to identify areas that needed closer examination. Any significant weaknesses in those controls are included in this report.

To obtain on overview of operations, we established an audit period of six years encompassing fiscal years 2006 through 2011. During the period from fiscal year 2006 through fiscal year 2011, ISAC conducted 14 procurements to obtain investment managers. We examined all 14 procurements to determine the process followed and how it changed over the time period. We also examined the College Illinois Statement of Investment Policy and all revisions to the policy during the audit period.

We conducted personnel testing for individuals whose salaries were charged directly to the College Illinois program. We examined program costs and determined reasons for increases in program costs over the audit period. We reviewed over 200 marketing materials to see how the Program was portrayed and how it changed over time.

We contracted with a consultant to conduct an independent asset allocation study of College Illinois Program investments to determine the overall level of risk associated with the Program's current alternative investment mix. The asset allocation study also compared the College Illinois portfolio to a standardized investment portfolio containing no alternative investments, as well as the investment portfolios of similar public prepaid tuition programs currently operating in the states of Michigan, Virginia, Washington, and Florida.

REPORT ORGANIZATION

The remainder of this report is organized into the following chapters:

- Chapter Two – Investing College Illinois Funds
- Chapter Three – Program Administration
- Chapter Four – Program Costs
- Chapter Five – Asset Allocation
- Chapter Six – Marketing of the Program

Chapter Two

INVESTING COLLEGE ILLINOIS FUNDS

CHAPTER CONCLUSIONS

The Illinois Student Assistance Commission (ISAC) circumvented the Illinois Procurement Code by selecting two investment managers (Kennedy Wilson and Lyrical-Antheus Realty Partners) outside of the normal procurement process. As discussed below, **it was later discovered that the former Director of Portfolio Management had become a limited partner in one of the investments**. During fiscal year 2011, these two investment managers received more than $2.6 million in investment fees.

The procurement process was also circumvented when awarding a contract to Mesirow Financial Investment Management (Mesirow) to perform due diligence services on the two investment managers. The fee structure for the due diligence services may have created an incentive for Mesirow to recommend the investments. Mesirow completed the first due diligence review prior to a contract to perform the work being in place.

ISAC did not comply with its own conflict of interest policy. A conflict of interest requirement contained in the Program's Investment Policy, which required an annual conflict of interest attestation by Commissioners and employees authorized to make investment decisions, was never implemented. We noted potential conflict of interest issues which included the following:

- There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. Both involved investment firms that were selected as investment managers, one of which received $20 million in funding.

- **In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager, Balestra Capital, while the selection process involving that investment manager was still ongoing –** specifically, a family partnership in which the Director of Portfolio Management had an economic interest made a $500,000 investment in Balestra Capital. He was also a member of the evaluation team that selected Balestra Capital.

- In another potential conflict of interest, the former Director of Portfolio Management introduced an investment with Lyrical-Antheus Reality Partners to ISAC and then, after leaving ISAC, became a limited partner in the investment.

In examining investment manager files, we noted one investment manager, Reynoso Asset Management, was provided funding that exceeded the amount authorized by $10 million.

We also noted that a private equity investment of $14 million was made with a single company, Fisker Automotive, despite several risks outlined in the Subscription Agreement.

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments. The selection of investment managers changed in several distinct ways:

- The makeup of the evaluation committee changed over the time period examined. The evaluation committee was more diversified in the earlier procurements including a Commissioner and a member of the Advisory Panel, in addition to staff at ISAC. Later procurements included only ISAC staff on the evaluation committee. Despite ISAC's State Purchasing Officer previously advising against it, the Executive Director of ISAC was included on the evaluation committee for three procurements. Participating on the evaluation team could allow the Executive Director to assert undue influence over the process.
- For earlier procurements, Marquette Associates, the Program's Investment Consultant, assisted in evaluating proposals but was removed from this role in later procurements. It is unclear why ISAC removed the Investment Consultant from the process. One effect was creating greater control for the now smaller evaluation teams, consisting solely of ISAC staff, over the selection process.
- The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session. By moving these discussions to closed session, ISAC removed transparency from the process.

We reviewed all 14 procurements involving the selection of investment managers during fiscal years 2006 through 2011. We noted several issues with the procurements:

- For the interviews/presentations of the finalists, none of the 14 procurements examined contained documentation on who attended or what was discussed.
- The procurement files lacked evidence of discussions regarding the rationale for the number of proposers selected for award. The number of winning vendors ranged from 1 to 13. The justification and rationale for the number selected was unclear.
- The procurement files were incomplete. Three of the 14 procurements lacked documentation on the initial scoring of the proposers and 1 of 14 lacked final scoring. Many evaluation forms lacked notes to justify the scores given.
- We noted mistakes during the scoring process for 4 of the 14 procurements. Some of these errors impacted the firms selected.
- For 3 of the 14 procurements, the evaluation criteria were changed to total only 450 points instead of the 500 points outlined in the Request for Proposals.

The Investment Advisory Panel (Panel), established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission. The Commission members approve all investment decisions and may lack the expertise that members of the Panel possess. Specifically, the Panel raised concerns over changing the Investment Policy to allow direct private equity investment. While the Panel raised concerns to the senior staff at ISAC, if those concerns are not, in turn, communicated to the Commission, the purpose of the Panel is negated.

In addition, the Panel failed to fulfill its statutory duties by not meeting at least twice annually as required by the Illinois Prepaid Tuition Act. The Panel also did not meet publicly with the Commission at least once annually to discuss issues and concerns relating to the Illinois Prepaid Tuition Program. There was also at least one vacancy on the seven-member Panel throughout the audit period.

The College Illinois Program had several other weaknesses in its internal controls over the investment process. These included:

- The Commission has not approved a new Investment Policy since January 2010 which violates the statutory requirement of annually adopting a comprehensive investment plan.

- The Portfolio Committee, which took over the rebalancing function from the independent Investment Consultant, failed to meet monthly as required in the Investment Policy and had not met since October 2010.

- The Investment Committee, which was to consist of at least two Commission members, was not formally established.

INTRODUCTION

House Resolution 174 directed us to examine the efficacy of the Program's administration and, in particular, ISAC's oversight and administrative capacity to evaluate and direct College Illinois investments. This chapter will focus on the controls over the investment process, the process to select investment managers, and the process used to invest funds. The next chapter will focus on other issues with program administration.

INVESTMENT POLICY

The Commission has not approved a new Investment Policy since January 2010 which violates the statutory requirement of annually adopting a comprehensive investment plan. The Illinois Prepaid Tuition Act states that the Commission shall **annually** adopt a comprehensive investment plan that shall specify the investment policies to be utilized by the Commission in its administration of the Illinois Prepaid Tuition Trust Fund (110 ILCS 979/30(b)). As of February 2012, the most recent revision to the Statement of Investment Policy was approved by the Commission in January 2010, more than two years ago.

The Statement of Investment Policy is one of the Program's primary control mechanisms. The purpose of the policy is to record long range policy, to promote understanding among various functional roles, and to address fiduciary responsibilities. The Executive Director is responsible for preparing the plan and the Commission is to approve any changes to the plan.

Since 2006, the College Illinois Statement of Investment Policy was revised nine times (see Exhibit 2-1). These revisions included both minor changes and significant changes in program philosophy. Changes to the Investment Policy included the following:

Exhibit 2-1
INVESTMENT POLICY REVISION DATES

Fiscal Year	Dates Revised
2006	11-18-05
2007	11-17-06 01-26-07 06-22-07
2008	06-27-08
2009	09-19-08 01-30-09 06-26-09
2010	01-22-10
2011	None

Note: No revisions had been approved in fiscal year 2012 up through February 2012.

Source: College Illinois investment policies.

- In January 2007, the Commission's philosophy toward policy modification was significantly changed. The prior philosophy stated that "While the Commission will review this Policy annually, the Commission recognizes that major changes to the Investment Policy can produce potentially damaging inconsistency." This opening sentence was replaced by "The Commission shall review this Policy annually with the intention to improve investment performance in collaboration with its staff, the Investment Advisory Panel, and professionals hired by the Commission to manage the portfolio."

- The most significant changes to the policy occurred in June 2008. Several new sections were added which appeared to strengthen the controls in place. These included adding and defining the roles of the Chief Investment Officer and an Investment Committee. A section on Internal Controls and Conflicts of Interest was added as well as a requirement to perform an asset liability modeling study.

- The June 2008 revision also included significant changes to the target asset allocation. The policy was changed to allow investments in hedge funds and infrastructure. Overall, the target allocation to alternative investments was increased from 10 percent to 25 percent. The policy also authorized direct private equity investments. This change allowed College Illinois to make a $12.7 million investment in ShoreBank which ultimately was valued to zero.

- The previous Investment Policy, prior to June 2008, contained four primary investment objectives: (a) to earn the highest possible total return consistent with levels of risk prudent to the cash flow requirements of the Fund, (b) to create a stream of investment returns to insure the systematic and adequate funding of actuarially determined benefits through contributions and professional management of the Fund assets, (c) to achieve 100 percent funding, and (d) to preserve the safety of principal. The June 2008 revision removed the fourth primary investment objective, to preserve the safety of principal, from the policy.

- The June 2009 policy revision substantially changed the asset classes. The fixed income asset classes were changed with the removal of intermediate bonds and core bonds and the addition of three new asset classes: broad fixed income, international government/credit, and mortgage/other. **These new asset classes were not defined anywhere in the policy.** A new asset class was added under real estate entitled "Real Estate (GSA)." **This asset class was also not defined anywhere in the policy.** We asked for definitions for these asset classes but were told there were no definitions. When we met with the Marquette Associates, the Program's Investment Consultant, they stated that some of the asset classes used were not institutionally accepted asset classes.

  Typically, the Investment Plan included operational guidelines for each of the asset classes. Operational guidelines included investment objectives, permissible investments, guidelines, and restrictions. However, when the new asset classes were added, there were no operational guidelines included for those asset classes. This was a significant oversight and weakened the controls over those investments.

- Also changed in June 2009 was the important responsibility of rebalancing the Fund to meet the guidelines established in the policy. This was changed from the Commission with the assistance of the Investment Consultant to the newly formed Portfolio Committee. This change will be discussed in more detail in the next section.

In examining the Statement of Investment Policy, we noted that the Program did not fully comply with the guidelines established in the policy. Some of these instances of non-compliance had a direct effect over the operations of the Program and will be discussed in the next section.

INVESTMENT POLICY	
RECOMMENDATION NUMBER **2**	***The Illinois Student Assistance Commission should ensure that its Statement of Investment Policy is approved on an annual basis as required by the Prepaid Tuition Act. The Commission should also conduct a formal review of its policy to ensure that asset classes are defined, that operational guidelines are included for each asset class, and that the Investment Policy is serving its intended purpose.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. With the addition of its new Chief Investment Officer and the retention of its new Investment Advisor, in December 2011 and January 2012, respectively, ISAC is in the process of revising its investment policy for approval by the Commission Board at its June 2012 meeting. The new policy will more clearly define asset classes and include operational guidelines for each asset class. The Commission Board will be asked to approve a Statement of Investment Policy on at least an annual basis. Prior to submission to the Commission Board, the

ISAC'S RESPONSE (continued)	agency will seek advice from the Investment Advisory Panel as to the Statement of Investment Policy. The approval by the Investment Committee of the Commission Board will be obtained prior to consideration by the full Commission Board.

INTERNAL CONTROLS OVER INVESTMENT PROCESS

Several internal controls over the investment process were not functioning as they should during parts of the audit period.

Portfolio Committee

The Portfolio Committee was not fulfilling its requirements as defined in the Investment Policy. A revision to the Investment Policy established the Portfolio Committee in June 2009. The Portfolio Committee consisted of the following three people:

1. The Executive Director of ISAC;
2. The Chief Investment Officer; and
3. The Director of Portfolio Management and Direct Investment.

The Investment Policy states "*The Portfolio Committee will meet monthly to review the portfolio, asset allocation and affect any rebalancing based on decisions of the Committee and acting within the guidelines of this Policy.*"

The Portfolio Committee failed to meet in 6 of 16 months from July 2009 through October 2010. Additionally, as of January 2012, there was no documentation to support that the Committee had met in the past 14 months (November 2010 through December 2011) since the Committee's last meeting in October 2010.

For the 10 meetings that did occur, it is unclear whether all Committee members attended the meetings because attendance records were not always kept. For the four Committee meetings where attendance was recorded, all required members attended two of those meetings. For the other two Committee meetings, two of three members attended the meetings in addition to at least one other Program staff who was not included as part of the defined Committee in the Investment Policy.

Prior to the establishment of the Portfolio Committee, the responsibility for rebalancing was with the College Illinois Investment Consultant. Rebalancing is the process of monitoring the portfolio to ensure that it complies with the Investment Policy. Based on the cash available to be invested, the Investment Consultant would analyze the portfolio and recommend where the funds should be invested to keep the portfolio in compliance.

Taking away the rebalancing function from the independent Investment Consultant, who had expertise in this area, provided more control over the portfolio to College Illinois management. Officials with Marquette Associates, the Program's Investment Consultant, stated that taking the function from them eliminated a paper trail. They would not find out what had been done until the following month when they received bank statements.

The last documented meeting of the Portfolio Committee was in October 2010. ISAC officials stated that members of the Portfolio Committee continued to communicate but those communications were likely not memorialized. Without further documentation, it is unclear who, if anyone, was performing the rebalancing function.

As of July 2011, the position of Director of Portfolio Management and Direct Investment had been eliminated. The Program was also without a Chief Investment Officer from July 2011 to December 2011.

PORTFOLIO COMMITTEE	
RECOMMENDATION NUMBER 3	***The Illinois Student Assistance Commission should assess the need for the Portfolio Committee. If the Commission decides to maintain the Portfolio Committee, it should re-define the membership of the Committee and ensure that it meets monthly to review and rebalance the investment portfolio. The Program's Investment Consultant should be included in any meetings of the Portfolio Committee.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. The Portfolio Committee, consisting of the Executive Director and Chief Investment Officer, conducted its first meeting on April 4, 2012, and will meet at least monthly going forward. The need for the Portfolio Committee, its makeup and its duties are under review. In the interim, the Investment Advisor will be asked to participate in future meetings. Any changes will be reflected in future amendments to the Statement of Investment Policy with advice from the Investment Advisory Panel. The Investment Committee of the Commission Board will be asked to approve changes to the Statement of Investment Policy prior to consideration by the full Commission Board.

Investment Committee

The Investment Committee, created by the Investment Policy, was not formally established. The Investment Committee was created in the June 2008 revision to the Investment Policy. The policy defines the committee as follows:

> *In this Policy, the "Investment Committee" refers to a committee consisting of at least two (2) members of the Commission appointed by the Chairman of the Commission, which will provide advice and guidance to the Chief Investment Officer on issues related to the investments of Fund assets.*

The policy states that the Investment Committee shall meet at least quarterly with the Chief Investment Officer. Duties of the Investment Committee include:

- Reviewing and discussing investment strategy and trading practice;
- Reviewing relationships with financial institutions, including investment managers, to ensure that investment managers were being selected and reviewed in accordance with the guidelines in the Investment Policy; and

- Monitoring use of all Program funds to ensure appropriateness and compliance with Investment Policy objectives.

The addition of an Investment Committee had the potential to strengthen the internal controls over the investment process. Not all Commission members had expertise in investment management so the formation of a committee that consisted of the Commission members that did have an expertise would be a positive for the Program.

However, the Investment Committee was not formally established. The Investment Policy which created the Investment Committee was approved at the June 2008 Commission meeting. At that meeting, two members of the Commission were mentioned as being on the Investment Committee. However, there was not a formal resolution naming the commissioners to the committee and no further documentation was provided to show that the Investment Committee ever met.

In June 2011, we met with the then interim Chief Investment Officer who was also acting as the Director of Portfolio Management. When asked about the Investment Committee, the interim Chief Investment Officer said he thought the Investment Committee and the Portfolio Committee were the same. As noted previously, the Investment Committee was to meet at least quarterly with the Chief Investment Officer. While the individual had only been in the position for approximately one month, it seems unusual that the interim Chief Investment Officer would be unaware of the Investment Committee which was specifically outlined in the Investment Policy.

In November 2011, the Commission Chairman appointed two members of the Commission to a sub-committee called the Investment Committee. It was unclear if this committee was intended to either act as, or replace, the Investment Committee specified in the Investment Policy. The duties mentioned in the November 2011 meeting minutes did not coincide with the duties specified in the Investment Policy. The duties mentioned in the meeting minutes included assisting not only the Chief Investment Officer but also the Investment Advisory Panel in reviewing the Investment Policy, rebalancing issues, and day-to-day activity within the portfolio.

INVESTMENT COMMITTEE	
RECOMMENDATION NUMBER 4	***The Illinois Student Assistance Commission should assess the duties of the newly formed Investment Committee and revise the Investment Policy accordingly. The Commission should then ensure that the Investment Committee is fulfilling the duties outlined in the Investment Policy.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval articulates the responsibilities of the Investment Committee of the Commission Board going forward. ISAC senior management is evaluating the best method(s) to communicate Investment Advisory Panel and Investment Committee proceedings to the Commission Board.

Investment Consultant

The role of College Illinois' Investment Consultant diminished over the course of the audit period which weakened the internal controls over the investment process. The Investment Consultant is an advisor retained to provide investment management advice and act as a fiduciary. The Investment Consultant's duties included the following:

- Conducting investment manager searches as authorized by the Commission and, as needed, assisting the Commission with the selection of investment managers and custodians.

- Providing "due diligence" reports or research on each of the Fund's investment managers.

- Monitoring the performance of the investment managers and providing the Commission with reports to determine their progress towards achieving the investment objectives.

- Providing the Commission and the Chief Investment Officer with a written report evaluating the performance of the Fund no later than 45 days after the end of each calendar quarter or more frequently if requested by the Chief Investment Officer and Commission.

- Assisting the Commission in reviewing the asset allocation of the Fund on a regular basis and rebalancing the portfolio to comply with the Investment Policy guidelines.

The role of the Investment Consultant noticeably changed in three areas:

- The removal of the rebalancing function from the Investment Consultant was discussed in the previous section on the Portfolio Committee.

- The Investment Consultant's role changed during the procurement process for obtaining new investment managers. This change will be discussed in the section on the process for selecting investment managers.

- The Investment Consultant was not asked to perform due diligence reports on two specific investment managers. This will be discussed in the section on improper selection of investment managers.

INVESTMENT ADVISORY PANEL

The Investment Advisory Panel (Panel), established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission. The Commission members approve all investment decisions and may lack the expertise that members of the Panel possess. While the Panel raised concerns to the senior staff at ISAC, if those concerns are not, in turn, communicated to the Commission, the purpose of the Panel is negated.

In addition, the Panel failed to fulfill its statutory duties by not meeting at least twice annually as required by the Illinois Prepaid Tuition Act. The Panel also did not meet publicly with the Commission at least once annually to discuss issues and concerns relating to the Illinois Prepaid Tuition Program. There was also at least one vacancy on the seven-member Panel throughout the audit period.

Duties of the Investment Advisory Panel

ISAC is to administer the College Illinois Program with the advice and counsel from the Investment Advisory Panel. The Illinois Prepaid Tuition Act states that the Panel shall consist of seven members who are appointed by the Commission:

- One that is recommended by the State Treasurer;
- One that is recommended by the State Comptroller;
- One that is recommended by the Director of the Governor's Office of Management and Budget; and
- One that is recommended by the Executive Director of the Board of Higher Education.

The remaining three members are recommended by the Commission. Each Panel member is to possess knowledge, skill, and experience in at least one of the following areas of expertise: accounting, actuarial practice, risk management, or investment management. Prior to being installed on the Panel, members are required to file written statements of economic interest with the Secretary of State. The Act further specifies the following:

- The Panel shall meet at least twice annually.
- At least once each year, the Commission Chairman is to designate a time and place at which the Panel shall meet publicly with the Commission to discuss issues and concerns relating to the Program.
- The Panel shall offer advice and counseling regarding the investments of the Program with the objective of obtaining the best possible return on investments consistent with actuarial soundness of the program. This includes reviewing and advising the Commission on provisions of the strategic investment plan and the annual report. The Panel at its own discretion also may advise the Commission on other aspects of the Program.

The Investment Policy also discussed the duties of the Panel. One responsibility that was added in the Investment Policy was for the Panel to assure that its members attend continuing educational forums, sessions, and seminars to improve knowledge on new investment products, strategies, and opportunities available in the marketplace.

Membership of the Investment Advisory Panel

There was at least one vacancy on the seven-member Panel throughout the audit period. We examined the membership of the Panel during fiscal years 2006 – 2011. During that entire time period, the seat that was to be filled by the Governor's Office of Management and Budget was vacant. In addition, the seat filled by the Comptroller was vacant from December 2008 through the end of fiscal year 2011. This seat was recently filled in September 2011. The membership of the Advisory Panel during the audit period is shown in Exhibit 2-2.

Exhibit 2-2
INVESTMENT ADVISORY PANEL – PAST MEMBERSHIP
Served During Fiscal Years 2006 – 2011

Name	Profession (when appointed)	Date Appointed	Tenure Ended
Recommended by:			
Treasurer			
George Clam	President, Oak Brook Bank	12-1998	07-2011
Comptroller			
Ed Madden	Vice President, First National Bank of LaGrange	01-2001	12-2008
Governor's Office of Management and Budget			
Vacant			
Illinois Board of Higher Education			
Michael Mann	Associate Director, Illinois Board of Higher Education	01-2002	07-2011
Illinois Student Assistance Commission			
Michael Neill	Trust Officer, First National Bank and Trust of Carbondale	12-1998	12-2005
Susan Keegan	Partner, D'Amato Keegan & Douglas	07-2006	09-2011
John Albin	President, Longview Capital Corporation	11-2002	06-2008
Alex Rorke	Loop Capital Markets	04-2009	09-2011
Ingrid Stafford	Associate Vice President for Finance; Controller, Northwestern University	09-2003	07-2008
Ed Donnellan	Three Zero Three Capital Partners, LLC	01-2009	06-2010
David Ikenberry	Associate Dean for Executive Programs; Professor of Finance with the College of Business, University of Illinois	06-2010	03-2011

Source: ISAC annual reports, Commission meeting minutes, and Advisory Panel meeting minutes.

The current Panel consists of six newly appointed members and is shown in Exhibit 2-3.

Exhibit 2-3
INVESTMENT ADVISORY PANEL – CURRENT MEMBERSHIP
As of December 2011

Recommended By	Name	Profession (when appointed)	Date Appointed
Treasurer	Louis Paster	Senior Vice President of Investments, UBS Financial Services	07-2011
Comptroller	Patrick Rea	Village Clerk for Tinley Park	09-2011
Governor's Office of Management and Budget	Vacant	Vacant	
Illinois Board of Higher Education	Karen Kissel	Assoc. Vice President and Comptroller, Governor's State University	07-2011
Illinois Student Assistance Commission	Jeanna Cullins	Fiduciary Services Practices, Hewitt Ennis Knupp	11-2011
Illinois Student Assistance Commission	Paul Hagy	Global Corporate Treasurer, AON Corporation	09-2011
Illinois Student Assistance Commission	Joy Winterfield	Portfolio Manager, Allstate Investments	09-2011

Source: Commission meeting minutes and Advisory Panel meeting minutes.

Meetings of the Investment Advisory Panel

As noted earlier, the Act requires that the Panel meet at least twice annually. In addition, **the Act requires that at least once each year, the Panel meet publicly with the Commission to discuss issues and concerns relating to the College Illinois Program.**

The Panel did not meet twice annually, as required, in three of the six years of the audit period. The meeting minutes reflect that the Panel did not meet twice in fiscal years 2008, 2010, and 2011.

In addition, the Panel failed to meet at least once each year with the Commission. Panel members attended a total of seven Commission meetings. Of the seven meetings, three were attended by only two Panel members and four were attended by only one Panel member. While Panel members occasionally attended Commission meetings, simply attending those meetings does not meet the requirements established in statute.

At only two meetings did Panel members speak addressing "issues and concerns relating to the Illinois prepaid tuition program." Both of these meetings occurred during fiscal year 2007. For the other five meetings with Panel members present, the minutes do not indicate that the Panel members participated in any discussion. For one meeting, in January 2009, the Commission Chairman announced that the meeting was a required joint meeting between the Commission and the Panel. However, the two Panel members in attendance did not participate in any discussion. Panel members did not attend any meetings during fiscal years 2006, 2008, or 2010.

Concerns Raised by the Investment Advisory Panel

In addition to the Panel members, Advisory Panel meetings were attended by the Program's Investment Consultant as well as senior staff such as the Executive Director and Chief Investment Officer. The Panel fulfilled its statutory requirement by offering advice and counseling regarding the investments of the Program.

While the Panel offered advice and counsel regarding the investments of the College Illinois Program during the meetings it held, the guidance that Panel members offered was not always relayed back to the Commission.

June 18, 2008 Meeting of the Investment Advisory Panel

The Panel discussed proposed changes to the Investment Policy which included changing the policy to allow direct private equity investments. The Panel members offered the following comments:

- A Panel member suggested that a limit be placed so that no more than $750,000 be invested with one company.
- A Panel member suggested if the College Illinois Fund was going to invest in private equity that it be limited to a fund-to-fund approach. She stated "...to have a direct investment of a specific company is not in alignment with what the fund should be doing." Another Panel member agreed.

One Panel member specifically asked the Executive Director to communicate the Panel's concern about a direct investment to the Commission. The Commission met nine days later on June 27, 2008. One Commission member specifically asked if the Investment Advisory Panel had approved the Investment Policy. The Chief Investment Officer replied that it had. ISAC's General Counsel then clarified that the Panel's changes were incorporated but the Panel is not required to approve the policy. **The meeting minutes do not indicate that the concerns raised by the Panel were communicated to the Commission.**

May 28, 2009 Meeting of the Investment Advisory Panel

The Panel discussed proposed changes to the Investment Policy. One change discussed was a new asset class called "Real Estate (GSA)" which would have a target allocation of 10 percent of the entire Fund. This change to the asset allocation structure would allow for the investment into GSA leased buildings. This refers to the U.S. General Services Administration which provides workspace for federal workers. ISAC officials discussed investing in a specific FBI building in Kentucky.

A Panel member expressed concern over committing $80 million into one building. Another Panel member emphasized the importance of due diligence.

The Investment Policy was approved at the next Commission meeting on June 26, 2009. The new asset class, Real Estate (GSA), was included in the policy. However, there was no specific mention of the asset class during the meeting. The Chief Investment Officer stated that the revisions being brought to the Commission had been reviewed with the Investment Advisory Panel. **The meeting minutes do not indicate that the concerns raised by the Panel were communicated to the Commission.**

Other Requirements

Other requirements of the Investment Advisory Panel were not completely fulfilled:

- The Act requires that Panel members file written statements of economic interest with the Secretary of State prior to installation as members. Two of the 15 Panel members examined did not file their statements until months after their first meeting.

- The Panel is also charged with reviewing and advising the Commission with regard to the annual report that describes the current financial condition of the Program. There is no documentation in the Panel meeting minutes that the Panel reviewed the annual reports. Minutes do show that the Panel reviewed the Actuarial Soundness Report for fiscal years 2005 and 2006 which is part of the annual report. None of the other minutes provided reflect that the Panel reviewed the actuarial reports for other years or the entire annual report in any of the years.

- The Investment Policy requires the Panel to assure that its members attend continuing educational forums, sessions, and seminars to improve knowledge on new investment products, strategies, and opportunities available in the marketplace. There was no documentation to support that this requirement was being met.

INVESTMENT ADVISORY PANEL	
RECOMMENDATION NUMBER 5	***The Illinois Student Assistance Commission should ensure that the Investment Advisory Panel fulfills its statutory duties including:*** • ***Meeting at least twice annually;*** • ***Meeting publicly with the Commission at least once per year;*** • ***Filing statements of economic interest in a timely fashion; and*** • ***Reviewing and advising the Commission with regard to the annual report.*** ***ISAC staff should ensure that any advice and counsel provided by the Panel regarding investments of the Program is relayed to the Commission. The Advisory Panel should submit its meeting minutes to the Commission to be reviewed at the subsequent Commission meeting.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval articulates the responsibilities and statutory duties of the Investment Advisory Panel. In addition, the General Counsel, as ISAC's Compliance Officer, has undertaken the preparation of an annual checklist of items that must be complied with including, without limitation, ensuring compliance by the Investment Advisory Panel with its statutory duties.

PROCESS FOR SELECTION OF INVESTMENT MANAGERS

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments. The selection of investment managers changed in several distinct ways:

- The makeup of the evaluation committee changed;
- The role of the Investment Consultant changed; and
- The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session.

We also noted several issues with the procurements including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the Request for Proposals, and lack of support justifying the number of proposers selected for award.

Exhibit
PROCUREMENTS FOR THE SELECTION OF INVESTMENT MANAGERS

Count	Asset Class	Award Date	Evaluation Committee	Proposals Received	Finalists Selected	Winning Vendors
1	Small-Cap Core Equity	09-19-05	▪ Four senior ISAC staff ▪ One Commissioner ▪ One Advisory Panel Member	24	4	2
2	International Equity	09-19-05	▪ Four senior ISAC staff ▪ One Commissioner ▪ One Advisory Panel Member	12	4	1
3	Domestic Large-Cap Core Equity Core Fixed Income	06-16-06	▪ Four senior ISAC staff ▪ One Commissioner ▪ One Advisory Panel Member	2	2	1
4	Intermediate Fixed Income	10-03-06	▪ Four senior ISAC staff ▪ One Commissioner ▪ One Advisory Panel Member	38	6	2
5	Core Fixed Income	07-02-07	▪ Four senior ISAC staff	33	7	3
6	Small-Cap Value Equity Large-Cap Growth Equity	11-19-07	▪ Three senior ISAC staff ▪ One Advisory Panel Member	2	2	1
7	Large-Cap Value Equity	02-06-08	▪ Four senior ISAC staff ▪ One Advisory Panel Member	23	5	4
8	Infrastructure	04-29-09	▪ Three senior ISAC staff	14	6	4
9	Private Equity	07-13-09	▪ Three senior ISAC staff	13	9	7
10	Real Estate	07-13-09	▪ Three senior ISAC staff	14	7	5
11	Intermediate Fixed Income	01-14-10	▪ Three senior ISAC staff	29	7	4
12	Hedge Funds	01-26-10	▪ Three senior ISAC staff (including Executive Director)	43	24	13
13	Large-Cap International Equity	03-26-10	▪ Four senior ISAC staff (including Executive Director)	25	Unknown	4
14	Manager of Managers	11-23-10	▪ Three senior ISAC staff (including Executive Director)	8	4	3

Source: OAG analysis of investment files and meeting minutes.

2-4
AND ISSUES WITH THOSE PROCUREMENTS

Member of evaluation team did not complete evaluation	Investment Consultant did not perform initial evaluations	Discussed during closed session	Interview/Presentations not documented	No documentation of initial scoring	Errors in scoring	Evaluation criteria changed	Potential conflict of interest issue	Count
			✓					1
			✓					2
			✓					3
			✓					4
✓			✓					5
			✓					6
			✓		✓			7
✓	✓		✓	✓			✓	8
	✓	✓	✓	✓	✓			9
	✓	✓	✓	✓	✓			10
	✓	✓	✓		✓			11
	✓	✓	✓			✓	✓	12
✓	✓	✓	✓			✓		13
	✓		✓			✓		14

Procurement Process

ISAC invests College Illinois funds with a number of investment managers in a variety of different asset classes. To obtain investment managers, ISAC goes through a competitive procurement process. This process includes:

- Issuing a Request for Proposals (RFP) that outlines the desired services;
- Collecting responses to the RFP;
- Establishing an evaluation committee;
- Conducting a manager search on all proposers;
- Performing an initial ranking of the proposers;
- Narrowing the proposers to a set of finalists for interviews/presentations;
- Performing a final ranking of the finalists;
- Determining the number of proposers selected for award;
- Submitting the list of selected proposers to the Commission for approval; and
- Announcing the vendors selected for award.

During the period from fiscal year 2006 through fiscal year 2011, ISAC conducted 14 procurements to obtain investment managers. We examined all 14 procurements to determine the process followed and how it changed over the time period. Exhibit 2-4 shows the 14 procurements and selected information for each. Exhibit 2-4 also shows issues with those procurements. These issues, which are discussed in more detail in the following sections include:

- All members of the evaluation team did not complete an evaluation;
- The Investment Consultant did not perform the initial evaluations;
- Discussion of the investment decisions moved to closed session;
- Interview/Presentations not documented;
- No documentation of initial scoring;
- Errors in scoring;
- Evaluation criteria changed; and
- Potential conflict of interest issues.

Evaluation Committee

The makeup of the evaluation committee changed over the time period examined. The evaluation committee was more diversified in the earlier procurements including a Commissioner and a member of the Advisory Panel, in addition to staff at ISAC. Later procurements included only ISAC staff on the evaluation committee.

For the last three procurements, the Executive Director of ISAC was included on the evaluation committee. This had not been done in any of the prior procurements. In a previous procurement, the Private Equity procurement, it was contemplated whether to include the Executive Director but the State Purchasing Officer for ISAC was opposed to the idea:

> *I suggest that [the Executive Director] be an observer/advisor on these RFPs but not an evaluator. We have a very tight time-frame and it is more difficult to schedule around [the Executive Director's] schedule. Moreover, [the Executive Director] has not been on any evaluation teams, I think by design.*

Participating on the evaluation team could allow the Executive Director to assert undue influence over the process. In the Hedge Funds RFP, which was the first time the Executive Director was on the evaluation committee, 24 firms were selected as finalists, far more than were selected for any other procurement examined. An e-mail from the Executive Director discussed his rationale for selecting finalists and noted "*Anything less than two dozen I will deem negligent.*"

We also noted:

- For two procurements (Core Fixed Income and Infrastructure), one of the Commission members was listed as being on the evaluation committee but did not complete evaluations. There was no documentation in the procurement files to indicate why he did not complete evaluations. For the Infrastructure procurement, the Director of Portfolio Management evaluated in his place but there was no official notice documenting this change. The Commission member had completed a conflict of interest form to be on the evaluation committee whereas the Director of Portfolio Management did not. For one procurement (Large-Cap International Equity), the Executive Director was included on the evaluation team, completed a conflict of interest form, but did not complete any evaluations. There was no documentation in the procurement files to indicate why he did not complete evaluations.

- For the earlier procurements, the Investment Consultant performed the initial evaluations that narrowed the list of proposals down to finalists. For later procurements, members of the evaluation committee performed the initial evaluations. However, this was not done consistently. In one instance, all evaluation committee members performed the initial evaluation but in others only part of the committee participated. It was unclear whether this was intended or was an oversight and all of the evaluation committee members should have been participating in the initial evaluations. This could have had an impact on the proposers selected as finalists.

Role of the Investment Consultant

The role of the Investment Consultant changed over the time period examined. In the earlier procurements the process was consistent. The Investment Consultant was provided all of the proposals. The Investment Consultant then conducted a detailed manager search on each of the proposers creating a report with the results. The Investment Consultant also analyzed and scored the proposals based on the criteria in the RFP. ISAC used this initial scoring to rank the proposals and select vendors as finalists. The Investment Consultant would then assist the evaluation committee in setting up interviews with the finalists. After the interviews and presentations, the evaluation committee scored the finalists and determined the number selected for award.

The Investment Consultant's role noticeably changed beginning with the Infrastructure procurement in 2009. For that procurement, the Investment Consultant conducted the detailed manager search but did not score the proposals. For the final six procurements shown in Exhibit 2-4, the Investment Consultant only conducted the detailed manager search for one procurement and did not score any of the procurements. In some cases, the evaluation team did the initial scoring but in other cases there was no documentation of the initial scoring in the procurement files. When we met with the Investment Consultant, Marquette Associates, officials discussed this change and stated that their role became basically secretaries setting up the meetings and providing space for the meetings. The Investment Consultant no longer provided any input.

ISAC's decision to remove the Investment Consultant from the procurement process weakened the process. One of the purposes of the Investment Consultant was to conduct investment manager searches and assist the Commission with the selection of investment managers. It is unclear why ISAC removed the Investment Consultant from the process. One effect was creating greater control for the now smaller evaluation teams, consisting solely of ISAC staff, over the selection process.

Commission Approvals of the Investment Managers

Another noticeable change was that the discussions regarding the selection of investment managers moved from open sessions of the Commission to closed sessions. As shown in Exhibit 2-4, the first eight procurements listed were all discussed during open session of the Commission meetings. The Commission members discussed the investment managers and voted whether to approve the selections presented to them.

Beginning with the Private Equity procurement in 2009, these discussions were moved to closed sessions of the Commission meetings. This continued for the next four procurements. Closed sessions are not open to the public and the discussions held are kept confidential for a period of time. The only part of the process that remained during open session was the vote on whether to approve the selections.

By moving these discussions to closed session, ISAC removed transparency from the process.

Other Procurement Issues

During our review of the 14 procurements, we noted several issues, some of which applied to the process as a whole while others were regarding specific procurements. These issues are discussed below.

Interviews/Presentations Not Documented

For the interviews/presentations of the finalists, **none** of the 14 procurements contained documentation on who attended or what was discussed. Good procurement practices dictate that the evaluation committee keeps accurate records of all meetings including interviews with proposers. This is especially important when the interviews have a direct impact on the scoring of the proposers.

For example, for the first procurement listed in Exhibit 2-4, Small-Cap Core Equity, interviews were worth 100 of the 500 points possible. However, the procurement file contained no documentation regarding the interviews. Documentation should include:

- A record of who attended from both the proposer and the evaluation team;
- Any presentation or other information provided by the proposer; and
- Questions asked by the evaluation team.

The only documentation found regarding interviews were schedules of when interviews were to take place and copies of PowerPoint presentations. This was found in some but not all of the procurement files. Since no records were kept of who attended, it is not known whether all evaluation team members attended the interviews. If evaluation team members are unable to attend, they should be provided information from the interviews to be used to score the proposals. The following case example describes an issue that occurred during the interview process for one of the procurements.

Hedge Funds Procurement (Awarded January 2010)

Initial scoring was completed September 25, 2009, by two members of the evaluation committee. The Executive Director was added as the third member of the evaluation team, completing his conflict of interest form on October 6, 2009. On October 13, 2009, ISAC's State Purchasing Officer e-mailed the members of the evaluation committee regarding a conversation with one of the vendors selected as a finalist. The vendor was scheduled for an interview on October 22, 2009.

> *I received a phone call from [Vendor]. He said that his firm came out to give a presentation already in reference to this RFP (I know that some presentations were already done before we went over the game plan) and wanted to verify that, in fact, they needed to come out again. They're in California.*
>
> *I know that [the Executive Director] did not get this presentation, however, my recommendation is that any further presentations or question and answer sessions with this*

firm be done over the phone...If there are any other firms that already came far and wide for this RFP, perhaps we can do the same. Local firms can come out again.

Since none of the interviews were documented, it is unclear how many firms had already given presentations and who was present at those presentations. The vendor mentioned in the above e-mail was ranked 7 of 43 after the initial scoring but fell to 14 in the final ranking and therefore was not one of the 13 selected. It is unclear whether the decision to do only a phone conference with this vendor had an impact on its final score.

Lack of Information Justifying the Number of Proposers Selected for Award

The procurement files lacked evidence of discussions regarding the rationale for the number of proposers selected for award. As shown in Exhibit 2-4, the number of winning vendors ranged from 1 to 13. The justification and rationale for the number selected was unclear.

Illinois' Standard Procurement Rules specify certain documentation that is to be maintained in the procurement file. This includes information on the evaluation committee's recommendation and management's decision (44 Ill. Adm. Code 1.2005(u)). The procurement files lacked any decision memos or other type of documentation explaining or justifying the number of firms selected. This is illustrated in the following examples.

Core Fixed Income Procurement (Awarded July 2007)

The Request for Proposals for the Core Fixed Income managers stated: "It is our intent to award part of the investment mandate to a qualified **emerging** investment management firm. An **emerging** investment manager is one that currently manages between 10 million and 2 billion in total assets."

Four **non-emerging** managers and three **emerging** managers were selected as finalists. After final scoring, one **non-emerging** manager was selected and two **emerging** managers were selected.

Vendor A (selected)	Non-emerging	442 points
Vendor B	Non-emerging	404 points
Vendor C	Non-emerging	404 points
Vendor D (selected)	Emerging	390 points
Vendor E	Non-emerging	371 points
Vendor F (selected)	Emerging	330 points
Vendor G	Emerging	305 points

The **non-emerging** manager selected was the highest scoring of the seven finalists. The two **emerging** managers ranked 4th and 6th of the seven finalists. **There was no explanation in the file to explain the rationale of why two emerging managers were selected while only one non-emerging manager was selected.** The 6th ranked **emerging** manager that was selected scored much lower than two **non-emerging** managers that were not selected.

Large-Cap Value Equity Procurement (Awarded February 2008)

Scoring was completed for this procurement on January 8, 2008. Based on procurement file documentation, it appeared that 3 of the 5 finalists were selected for award. However, a January 15, 2008 e-mail stated "A decision was made late yesterday to hire a fourth vendor..." **There was no other documentation regarding the decision.** On February 6, 2008, four vendors were officially announced for award.

ISAC later provided a decision memo that was not in the official procurement file. The decision memo explained in detail the rationale for selecting the four vendors.

Infrastructure Procurement (Awarded April 2009)

Scoring for this procurement was completed in March 2009. An e-mail from ISAC's State Purchasing Officer (SPO) stated:

> *I also need a written reason why [vendor] was not selected, though they scored higher than two of the four selected vendors. I need to be able to justify the selection in the event of a protest, or, in the event of an audit.*

The Chief Investment Officer replied:

> *[Vendor] was not selected in the final four since the committee gave a higher score to another closed-end fund manager...Further, the estimated close for the [vendor] Fund is May 2010, meaning they are still early in their fund raising, which does not meet our requirements or needs for the College Illinois Fund.*

This is the type of information that should be formalized in a decision memo to support the vendors selected for award.

Hedge Funds Procurement (Awarded January 2010)

Scoring for this procurement was completed in December 2009. ISAC's Contract Administrator asked ISAC's State Purchasing Officer to confirm the number of winning vendors. The SPO had indicated five winning vendors. The Contract Administrator e-mailed: "*Please confirm that this is correct. The reason I ask, is that the Commission agenda item mentioned 13 vendors.*" The SPO replied: "*13 winning vendors?*"

As evidenced in the above e-mail, the SPO was unaware that 13 vendors were selected. The number of vendors selected in this procurement, 13, was more than in any other procurement examined. **There was no decision memo or discussion of any type in the procurement file to explain the rationale for selecting 13 vendors.**

Incomplete Scoring Documentation

Three of the 14 procurements lacked documentation on the initial scoring of the proposers. Illinois' Standard Procurement Rules specify certain documentation that is to be maintained in the procurement file. This includes completed score sheets for individual evaluators and the evaluation committee's combined score sheets (44 Ill. Adm. Code 1.2005(u)).

For the three procurements that lacked documentation on the initial scoring, it was unclear how the finalists were selected. This is illustrated in the following example:

Infrastructure Procurement (Awarded April 2009)

ISAC's State Purchasing Officer asked for a rationale for narrowing down the proposers from 14 to 6. The Chief Investment Officer replied:

> *The review committee narrowed the search from 14 to 6 after a thorough analysis of investment thesis, product offering and risks associated with each manager's proposal. The six that made the initial screen met our minimum requirements for the asset class. The others did not.*

There was no scoring or any other documentation to support this decision.

For one of the 14 procurements, there was no documentation of the final scoring in the procurement file:

Large-Cap International Equity Procurement (Awarded March 2010)

The initial scoring of the 25 proposers was done by three of the four members of the evaluation team. An e-mail stated that it was decided to invite the top 15 percent for oral presentations. There was no other rationale for why the top 15 percent was decided on or which specific vendors were selected as finalists. **There was no further scoring documentation in the file on final round scoring.**

ISAC later provided final scoring documents that were not in the official procurement files. These scoring documents show that the same three evaluators also scored the finalists. The Executive Director, who was initially listed as an evaluator, did not score the proposals. The final scoring documents show that 4 of the 25 proposers were selected as finalists and scored. Based on the initial scores given, this represents the top 10 percent, not the top 15 percent. The top 15 percent, based on those within 15 percent of the top score given, would have included 8 proposers. All four of the vendors selected as finalists were also selected for award.

Lack of Notes to Support Scores Given

The evaluation forms, particularly for the later procurements, contained little to no justification for the scores given. Illinois' Standard Procurement Rules specify certain documentation that is to be maintained in the procurement file. This includes completed score sheets for individual evaluators including notes (44 Ill. Adm. Code 1.2005(u)). Completed score sheets should be supported by thorough and appropriate comments. Without this type of documentation, it is difficult to determine reasons for any discrepancies in scoring. This is illustrated in the following example:

Hedge Funds Procurement (Awarded January 2010)

The initial scoring of the proposers was done by two of the three members of the evaluation committee. Comparing the initial scores given to the final scores showed disparities for these two evaluators. For example, Reynoso Asset Management, 1 of the 13 firms ultimately selected for award, was given a score of 260 points (out of 450) by the Chief Investment Officer and a score of 307 points by the Director of Portfolio Management. Both of these scores had some, albeit minimal, comments to accompany the scores. In the final round, after interviews, the Chief Investment Officer gave a score of 160 points, 100 points lower, and the Director of Portfolio Management gave a score of 411 points, 104 points higher. Neither of these final scores had any notes or comments to support the scores given.

This example also illustrates the disparity of scores amongst the evaluators. The third member of the evaluation team, the Executive Director, scored Reynoso 410 points in the final scoring. In summation, this vendor received scores of 160, 410, and 411. There were no notes or comments to support the final scores that might explain the wide disparity in scores given.

In the final procurement, one of the preliminary evaluations was handwritten on a blank sheet of paper with scores listed for the eight proposers. No further notes were listed and there was no name on the sheet. This was scanned and saved electronically indicating that it was the Executive Director's evaluation.

Errors in Scoring

We noted mistakes during the scoring process for 4 of the 14 procurements. Some of these errors impacted the firms selected. Each of the errors is discussed in the following case examples.

Large-Cap Value Equity Procurement (Awarded February 2008)

Two of the proposers had similar names. After the first round of scoring, one was ranked 5th and the other ranked 9th. The top five were selected as finalists. Based on the final scoring instruments, the 9th ranked firm was inadvertently advanced as finalist and scored instead of the 5th ranked firm. The 9th ranked firm was not one of the four vendors selected for award. However, it is not known how the 5th ranked firm would have finished in the final scoring had it been included as a finalist.

Private Equity Procurement (Awarded July 2009)

In scoring the Private Equity procurement, 9 of the 13 proposers advanced as finalists. Seven vendors were chosen for award. There was no discussion or decision memo explaining the rationale for selecting seven firms for award. The only indication in the file was a sheet that listed the scores for the nine finalists. The top seven were highlighted to indicate that they "Scored over 90%." This was calculated based on the top scoring vendor which received 450 points and included vendors that scored within 90 percent of the top score. However, this calculation was done incorrectly. The sheet in the file used 410 points as the cutoff line when actually 90 percent of 450 is equal to 405 points. The 8th ranked vendor scored 409 points which was over 90 percent compared to the top ranked score. Based on those criteria, the 8th ranked vendor should have also been selected for award.

Real Estate Procurement (Awarded July 2009)

The scoring sheets for the three evaluators were maintained as Microsoft Excel spreadsheets. There was an error in the formula used for calculating the total score for the finalists. The scores for one evaluator were omitted from the formula calculation while another evaluator's were included twice. This did not have an impact on the five vendors selected. We corrected the formula and determined that the top five vendors remained the same.

Intermediate Fixed Income Procurement (Awarded January 2010)

For preliminary scoring, the scoring sheets for the two evaluators were maintained as Microsoft Excel spreadsheets. When tabulating the scores, the scores for one of the evaluators were inadvertently used in place of the second evaluator's scores for 27 of the 29 proposers. These incorrect scores were then used to determine the finalists. This error resulted in one proposer being included as finalist that otherwise would not have been included. However, the proposer was not one of the vendors selected for award.

Evaluation Criteria Changed

For 3 of the 14 procurements, the evaluation criteria were changed to total only 450 points instead of the 500 points outlined in the RFP. Illinois' Standard Procurement Rules, regarding selection procedures for professional and artistic services, state that proposals shall be evaluated only on the basis of evaluation factors stated in the Request for Proposals (44 Ill. Adm. Code 1.2035(h)). This change first occurred for the Hedge Funds procurement.

Hedge Funds Procurement (Awarded January 2010)

The Request for Proposals stated that the total number of points would be 500. The 500 points were divided up into five elements which included as the final element the following:

- Other (oral interview, novel approaches to fund management) 200 points

The scoring sheet, however, changed the total possible points to 450 and changed the total for this category to 150 points as follows:

- Other (150 points)
  - References (no points allocated)
  - Fits with ISAC's investment approach (100 points)
  - Novel approaches to fund management consistent with ISAC's vision (50 points)

An e-mail from ISAC's State Purchasing Officer discussed the change to the scoring sheet and stated that reference scores would be given to the finalists. However, this was never done.

In the next procurement for Large-Cap International Equity investment managers, the Request for Proposals changed the "Other" category slightly to: "Other (references, novel approaches to fund management, good fit) 200 points." However, an e-mail from the Contract Administrator to the SPO regarding the scoring criteria indicated that the "Other" category was broken down the same as the Hedge Funds RFP and was worth only 150 points.

Changing the evaluation criteria from what is specified in the RFP violated the Standard Procurement Rules and may have had an impact on the vendors selected for award.

<table>
<tr><th colspan="2">PROCUREMENT PROCESS FOR SELECTION OF INVESTMENT MANAGERS</th></tr>
<tr><td>RECOMMENDATION NUMBER
6</td><td>The Illinois Student Assistance Commission should examine its process used to select investment managers and determine the role of its Investment Consultant in the process. The Commission should also ensure that:

• Interviews/presentations are documented including who attended, the presentation given, and questions asked by evaluators;
• Selections are supported by rationale that justifies the number of vendors selected;
• The procurement files contain all completed evaluations. The evaluations should also include notes that support the scores given;
• The combined score sheets are reviewed to ensure they are free of errors; and
• The proposals are evaluated based on the criteria specified in the Request for Proposals.</td></tr>
<tr><td>ISAC'S RESPONSE</td><td>The Illinois Student Assistance Commission accepts this Recommendation. ISAC will comply with the Illinois Procurement Code in its selection of investment managers. Further, as of January 1, 2011, the process for procurement of investment managers is currently subject to review and approval by the Executive Ethics Commission's procurement officer assigned specifically to ISAC.</td></tr>
</table>

IMPROPER SELECTION OF INVESTMENT MANAGERS

The Illinois Student Assistance Commission circumvented the Illinois Procurement Code by selecting two investment managers (Kennedy Wilson and Lyrical-Antheus Realty Partners) outside of the normal procurement process. The procurement process was also circumvented when awarding a contract to Mesirow Financial Investment Management (Mesirow) to perform due diligence services on the two investment managers. The fee structure for the due diligence services may have created an incentive for Mesirow to recommend the investments.

Request for Proposals for Real Estate Investment Managers

On May 1, 2009, ISAC issued a Request for Proposals for real estate investment managers for the College Illinois Program. The purpose was to seek investment managers to invest College Illinois funds in different real estate categories such as opportunistic, distressed debt, secondary real estate, and value added real estate. Nowhere in the RFP does it mention procuring firms to provide due diligence services.

Fourteen vendors responded to the RFP. Five vendors were selected for award. These five were approved by the Commission at its June 26, 2009 meeting. The official award announcement was July 13, 2009. Only two of the five selected for award have received funds to invest – the number one ranked firm and the number three ranked firm. At the November 13, 2009 Commission meeting, the third ranked vendor, Mesirow Financial Investment Management was approved to receive funding not to exceed $25 million. Exhibit 2-5 shows the timeline for the real estate RFP and subsequent due diligence services performed.

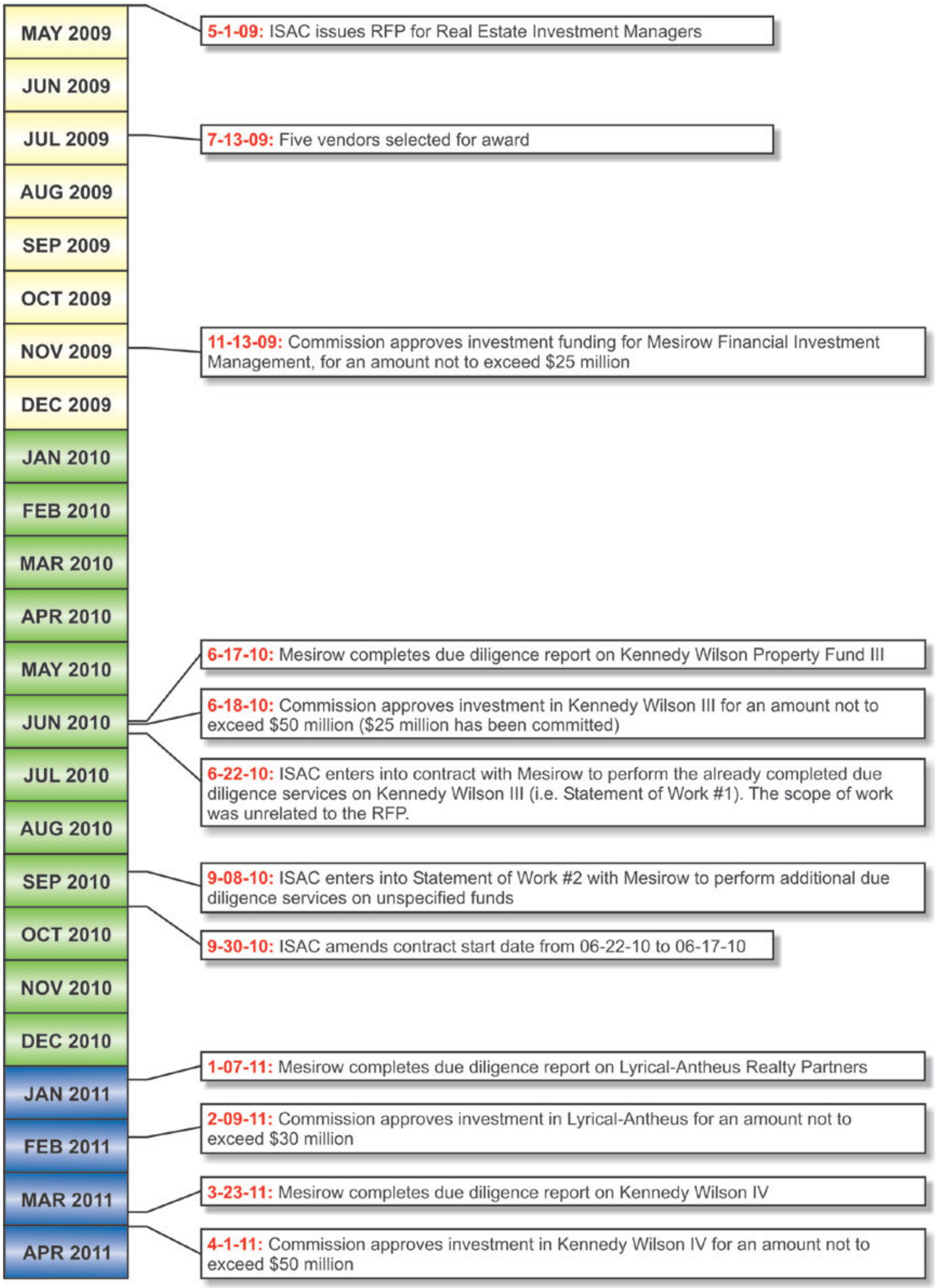
Due Diligence Services

On June 22, 2010, ISAC entered into a contract with Mesirow to perform due diligence services. The contract was issued as a result of Mesirow's selection from the May 1, 2009 RFP for real estate investment managers but was separate from the November 2009 approval to receive up to $25 million in funding. Under the description of supplies and services, the contract stated: "Real Estate Investment Manager for College Illinois."

Awarding this contract to Mesirow violated the competitive procurement requirements of the Illinois Procurement Code. The Illinois Procurement Code (30 ILCS 500/35-30 and 35-35) requires that all professional and artistic services greater than $20,000 be awarded using a competitive RFP process. In addition, the Standard Procurement Rules specify that the RFP include the type of services required and a description of the work involved (44 Ill. Adm. Code 1.2035(h)). **The contract for due diligence services was unrelated to the May 1, 2009 RFP.** Pricing for the due diligence services was not included in Mesirow's proposal and was negotiated at a later date, outside of the competitive procurement process.

Exhibit 2-5

TIMELINE FOR REAL ESTATE RFP AND SUBSEQUENT DUE DILIGENCE SERVICES



Source: OAG analysis of ISAC documents.

The contract went on to specify that a Statement of Work shall be entered into that more fully describes the services being provided. It added that **no work shall be done or costs incurred unless ISAC has agreed in writing to the terms of the Statement of Work**. Statement of Work #1 was attached to the contract and specified that Mesirow would perform a financial due diligence investigation. The Statement of Work specified the fund, the Kennedy Wilson Property Fund III, that was to be examined. Upon completion of the due diligence report, Mesirow was to be paid $85,000. In addition, if ISAC invested in the fund, Mesirow would be paid an acquisition fee equal to 0.75 percent of the total capital commitment.

The due diligence report on Kennedy Wilson III was completed June 17, 2010, which was five days prior to the execution date of the contract. The Commission approved investing in the fund for an amount not to exceed $50 million at its June 18, 2010 meeting which was four days prior to the execution date of the contract. More than three months later, on September 30, 2010, ISAC amended the contract to change the start date from June 22, 2010, to June 17, 2010, to coincide with the date the due diligence report was completed.

It is unclear when the due diligence was first begun. The report noted that Mesirow met with officials with Kennedy Wilson as far back as March 2009. In fact, the due diligence report for Kennedy Wilson III noted that Mesirow had reviewed Kennedy Wilson on behalf of other discretionary funds managed by Mesirow but elected not to pursue the investment for reasons highlighted in the report. Despite this, Mesirow recommended that ISAC invest in Kennedy Wilson.

On September 8, 2010, ISAC entered into Statement of Work #2 with Mesirow to perform financial due diligence services for prospective investments. Unlike Statement of Work #1, the specific investments were not identified.

The term of the contract, as specified in Statement of Work #2, was to be from September 8, 2010, through June 30, 2013. Statement of Work #2 also specified the compensation to Mesirow for the advisory services. Exhibit 2-6 shows the specific fees outlined in both statements of work and those fees are described below.

- Engagement fees were to be paid on a quarterly basis. **The statement of work does not define engagement fees nor specify what services the engagement fees would cover.** Since Mesirow would be paid for each due diligence report, it is unclear why the agreement would include engagement fees. ISAC has paid Mesirow $140,000 in engagement fees but could be liable for up to $390,000 based on the engagement fees outlined in the statement of work.

- Both statements of work included due diligence fees. These fees equaled $85,000 for each completed due diligence report. Mesirow completed three due diligence reports. ISAC has paid Mesirow $85,000 but could be liable for up to $255,000 for due diligence fees.

- Both statements of work included acquisition fees. If ISAC invested in the funds, Mesirow would receive an acquisition fee equaling 0.75 percent of the aggregate dollar amount of the capital commitment. By paying Mesirow on this basis, ISAC may have created an incentive for Mesirow to recommend the investments. ISAC has paid Mesirow $46,875 in acquisition fees but could be liable for up to $787,500 based on the capital committed.

Exhibit 2-6
FEES PAYABLE FOR DUE DILIGENCE SERVICES UNDER THE MESIROW CONTRACT

Type of Fee	Contract Amount	Amount Paid
Engagement Fees (payable on:)		
09-08-10	$35,000	$35,000
09-30-10	35,000	35,000
12-31-10	35,000	35,000
03-31-11	35,000	35,000
06-30-11	31,250	
09-30-11	31,250	
12-31-11	31,250	
03-31-12	31,250	
06-30-12	31,250	
09-30-12	31,250	
12-31-12	31,250	
03-31-13	31,250	
Total Engagement Fees	**$390,000**	**$140,000**
Due Diligence Fees		
Kennedy Wilson III (completed 06-17-10)	$85,000	$85,000
Lyrical-Antheus (completed 01-07-11)	85,000	0
Kennedy Wilson IV (completed 03-23-11)	85,000	0
Total Due Diligence Fees	**$255,000**	**$85,000**
Acquisition Fees		
(0.75% of Capital Commitment)		
Kennedy Wilson III ($25 million committed)	$187,500	$46,875
Lyrical-Antheus ($30 million committed)	225,000	0
Kennedy Wilson IV ($50 million committed)	375,000	0
Total Acquisition Fees	**$787,500**	**$46,875**
Total	**$1,432,500**	**$271,875**

Source: OAG analysis of Mesirow contract and invoices.

In total, based on the due diligence reports completed, Mesirow had the potential to earn in excess of $1.4 million. As of June 30, 2011, Mesirow had been paid $271,875. Due diligence analysis was typically provided by the Program's Investment Consultant. In fiscal year 2011, the Investment Consultant was paid a retainer $140,000 for all services performed. Any due diligence analysis would have been included in the retainer amount. It is unclear why ISAC would pay an outside vendor $271,875 for services that could have been provided by its Investment Consultant at no additional cost. ISAC officials stated that the contract with Mesirow has been cancelled. However, ISAC could still be liable for future payments up to the total of $1.4 million shown in Exhibit 2-6.

Investment Managers Selected Outside of the Normal Procurement Process

ISAC circumvented the Illinois Procurement Code by selecting the two investment managers, Kennedy Wilson and Lyrical-Antheus, outside of the normal procurement process. As noted previously, the Illinois Procurement Code (30 ILCS 500/35-30 and 35-35) requires that all professional and artistic services greater than $20,000 be awarded using a competitive request for proposal process. Neither Kennedy Wilson nor Lyrical-Antheus, who were the subjects of the due diligence reports, were one of the five firms selected as real estate investment managers in the May 1, 2009 RFP. Three of the five firms selected for award in the May 1, 2009 RFP have never received funding.

It is unclear how Kennedy Wilson and Lyrical-Antheus were initially identified. According to the former Chief Investment Officer, the Lyrical-Antheus investment was introduced to ISAC by the Director of Portfolio Management. By the time the investment was approved, the Director of Portfolio Management was no longer with the College Illinois Program. In April 2011, it was discovered that the Director of Portfolio Management had become a limited partner in Lyrical-Antheus. This is discussed in more detail in the next section on conflicts of interest.

During fiscal year 2011, Kennedy Wilson and Lyrical-Antheus received more than $2.6 million in investment fees.

PROCUREMENT LAW NOT FOLLOWED	
RECOMMENDATION NUMBER 7	***The Illinois Student Assistance Commission should comply with the requirements set forth in the Illinois Procurement Code and administrative rules in procuring professional and artistic services. Prior to approving funding, the Commission should ensure that investment managers were selected through a competitive selection process.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. ISAC will comply with the Illinois Procurement Code in its procurement of professional and artistic services. Further, as of January 1, 2011 the process for procurement of professional and artistic services is currently subject to review and approval by the Executive Ethics Commission's procurement officer assigned specifically to ISAC.

CONFLICT OF INTEREST AND ETHICS POLICIES

ISAC did not comply with its own conflict of interest policy. A conflict of interest requirement contained in the Program's Investment Policy, which required an annual conflict of interest attestation by Commissioners and employees authorized to make investment decisions, was never implemented.

There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. Both involved investment firms that were selected as investment managers, one of which received $20 million in funding.

There were also two instances where the Director of Portfolio Management made personal investments with vendors that were selected to be investment managers. In one instance, the Director of Portfolio Management made a personal investment while the selection process was still ongoing – specifically, a family partnership in which the individual had an economic interest made a $500,000 investment in Balestra Capital. He was also a member of the evaluation team that selected the vendor. In the other instance, the individual introduced the investment to ISAC and then, after leaving ISAC, became a limited partner in the investment.

ISAC has three different ethics or conflict of interest policies that impact the College Illinois Program:

- An agency wide employee ethics policy;
- A conflict of interest policy established as part of the College Illinois Investment Policy; and
- A conflict of interest statement that is required for members of an evaluation team.

Agency Wide Employee Ethics Policy

ISAC has an agency wide employee ethics policy that has been in place since 1992 and was last updated in 2006. The purpose of the employee ethics policy is to "foster ethical standards of conduct for its employees, which will assure that business decisions are not influenced by personal financial gain or other influences inconsistent with ISAC's mission of serving the state of Illinois and our clients with the utmost integrity."

The ethics policy contains a section on conflict of interest which states:

A conflict of interest exists when an employee's private interests, usually of a personal, financial or beneficial nature, conflict with the employee's duties and responsibilities at ISAC. Any conduct that would lead a reasonable person, knowing all the facts, to the conclusion that an employee might be biased is unacceptable. Even an appearance of a conflict of interest may, in fact constitute a conflict...

The policy is intended to dissuade employees from participating in outside activities that may conflict with their responsibilities to ISAC. All instances of a possible conflict of interest are to be fully and timely disclosed to the Ethics Officer in writing. The Ethics Officer is to determine whether an actual conflict of interest exists. The conflict of interest section also notes the requirement for certain employees to file an annual Statement of Economic Interest with the Secretary of State.

Investment Policy's Conflict of Interest Requirement

In June 2008, the Program's Statement of Investment Policy was revised to include a section on conflict of interest. The policy stated that Commission members, employees and any other persons authorized to make investment decisions of any Fund assets on behalf of the Commission must refrain from personal business activity that could potentially conflict with proper execution of the Investment Policy or impair their ability to make impartial decisions. The policy goes on to state that under no circumstances shall a participant in the investment process receive any type of financial gain, either directly or indirectly, from the investment of any Program funds. Any real or potential conflict of interest must be reported to the Chief Financial Officer and Ethics Officer.

The Chief Investment Officer was responsible for implementing an annual attestation to comply with the Investment Policy requirement. **However, the annual attestation was never implemented.** When asked to provide the annual attestations, ISAC was unable to provide them. The only documents provided were conflict of interest certifications dated in September and October 2008. The certifications were related to one specific investment, the direct investment with ShoreBank.

Evaluation Team Conflict of Interest Requirement

When selecting investment managers, ISAC establishes an evaluation team to evaluate proposals. Members of the evaluation team are required to complete a conflict of interest statement prior to participating on the evaluation team. When reviewing procurement files, we noted that two types of conflict of interest statements were used.

One form referred to specific sections of the Procurement Code and also referenced the State Officials and Employees Ethics Act. In addition, each evaluation team member attested to the following:

> *I hereby certify that neither I nor any members of my immediate family have a material, personal, financial or fiduciary interest that would affect my participation in this project.*
>
> *I am aware that my participation in this project will involve my knowledge of official information and possible vendor proprietary information not publicly known. I agree not to disclose any information gained during the course of my service on this project, except to other State employees who may in the normal course of State business have a need for such information, until such information becomes public record.*
>
> *If I should become aware of any situation that could conflict with any of the representations above, or that might indicate a conflict of interest or create the appearance of a conflict or other impropriety, I will notify management immediately.*

A second conflict of interest form used for evaluation team members listed all of the vendors that responded to the Request for Proposals. The form asked "If you, or a member of your immediate family, have a current or previous business/employment or personal relationship with any of these vendors..." to indicate the vendor and the nature of the relationship. The form indicated that a determination would then be made regarding any potential conflict of interest.

Potential Conflicts of Interest

When reviewing the selection of investment managers, we noted issues with complying with the conflict of interest requirements and several instances of potential conflicts of interest that were not disclosed. These include the following:

- The former Executive Director had a previous working relationship with Reynoso Asset Management (Reynoso), one of the vendors that responded to the Hedge Funds RFP. He worked at the same investment firm with the Chief Executive Officer of Reynoso. The Executive Director was a member of the evaluation team for this procurement. Despite the conflict of interest form specifically mentioning previous business relationships, he indicated no conflicts of interest. Reynoso was later one of the vendors selected for award and has received $20 million in funds.

- The former Executive Director had a previous relationship with Global Infrastructure Partners, one of the vendors that responded to the Infrastructure RFP. He served on the Beloit College Board of Trustees with the Co-Founder/Managing Partner of Global Infrastructure Asset Management. This relationship would at a minimum qualify as an appearance of a potential conflict of interest that would require disclosure under ISAC's ethics policy. Global Infrastructure was one of the vendors selected for award.

  While the award announcement was on April 29, 2009, Global Infrastructure was not authorized for funding until February 2011. The fund the Commission approved in February 2011 was called the GEO Investors Renewable Infrastructure Fund which was formed by Global Infrastructure. However, it was not formed until October 2010, which was a year and a half after the RFP was awarded. Documents provided to the Commission at its February meeting noted the following:

  > *Although one of the Fund's Principals has committed to investing in the Fund and the Fund anticipates further investors, ISAC would be the sole third party investor in the Fund as of February 9, 2011. The Fund has no operating history.*

  At its February 9, 2011 meeting, the Commission approved investment funding for Global Infrastructure for an amount not to exceed $30 million. This authority was rescinded by the Commission at its July 8, 2011 meeting.

- The Associate General Counsel for ISAC has a relationship with one of the Hedge Fund managers, Reynoso Asset Management. He is the brother of the Chief Executive Officer and worked at the same investment firm for ten years. It should be pointed out that the Associate General Counsel was hired July 9, 2010, and therefore did not work for ISAC during the hedge funds procurement and had no involvement. However, the Associate General Counsel works directly with the investment firms and the relationship would be required to be disclosed under the annual attestation requirement in the Investment Policy. As noted previously, this attestation has not been implemented. In October 2010, the funding authorization limit for Reynoso was erroneously exceeded by $10 million. This is discussed in more detail in the next section.

- During our testing of 14 procurements for the selection of investment managers, we noted one instance where an evaluator did not complete a conflict of interest form. In addition, in 3 of 14 procurements, evaluators did not properly complete conflict of interest forms by failing to check yes or no regarding whether they had a conflict.

There were also two instances where the Director of Portfolio Management made personal investments with vendors that were selected to be investment managers. In one instance, the Director of Portfolio Management made a personal investment during the selection process. He was also a member of the evaluation team that selected the vendor. In the other instance, he introduced the investment to ISAC and then, after leaving ISAC, became a limited partner in the investment. These instances are described in the following case examples.

Case Example One

ISAC issued an RFP for hedge fund managers on July 29, 2009. A three person evaluation team consisting of the Director of Portfolio Management, the Executive Director, and the Chief Investment Officer evaluated the proposals. Balestra Capital was the top ranked proposer and 1 of 13 vendors selected for award. Evaluations were completed by December 14, 2009. The Commission approved the selection of the firms at its January 22, 2010 meeting.

At some point prior to the Commission approving the selection, the Director of Portfolio Management made a personal investment in Balestra while acting as the point person on negotiations. Specifically, a company in which he owned a 28.3 percent partnership interest invested $500,000 in Balestra. It should also be noted that a second company owned by him acted as the General Partner of the first company.

On January 28, 2010, when the General Counsel became aware of the situation, she e-mailed the Chairman of the Commission requesting to meet with the Chairman to discuss the potential conflict of interest issue and raising her concerns about the personal investment. The General Counsel indicated in the e-mail that she was not comfortable with the personal investment but was asked to re-think her position.

A certification, dated January 29, 2010, and signed by the parties involved, disclosed the details of the investment and stated that it was effective January 1, 2010. ISAC's General Counsel was not one of the individuals who signed the certification. ISAC subsequently invested $55 million with Balestra.

The personal investment by the Director of Portfolio Management described in Case Example One appeared to violate all three conflict of interest policies described above. This investment was also not disclosed on his Statement of Economic Interest filed May 3, 2010, with the Secretary of State.

The next case example is slightly different as the investment occurred after the Director of Portfolio Management had left ISAC. It is, however, still problematic.

Case Example Two

At its February 9, 2011 meeting, the Commission approved an investment of up to $30 million with Lyrical-Antheus Realty Partners. Lyrical-Antheus was a real estate investment manager and was selected outside of the normal procurement process. (This is discussed in more detail in the previous section.) According to the former Chief Investment Officer, **the investment was introduced to ISAC by the Director of Portfolio Management**. By the time the investment was approved, the Director of Portfolio Management was no longer with the College Illinois Program.

On April 27, 2011, Lyrical-Antheus provided ISAC a list of limited partners. The now former Director of Portfolio Management was listed as a limited partner. His investment totaled $185,000. Documentation from Lyrical-Antheus indicated that he submitted documents committing to the investment on February 25, 2011. It is unknown when the investment was first contemplated or whether the Director of Portfolio Management had a prior relationship with Lyrical-Antheus.

CONFLICT OF INTEREST POLICY	
RECOMMENDATION NUMBER **8**	***The Illinois Student Assistance Commission should assess its conflict of interest policy making any needed revisions including appropriate disclosures of potential conflicts prior to procurement evaluation. Revisions should also include investment restrictions related to potential or recent ISAC investments for any ISAC employee involved in the investment process or members of the Commission or Investment Advisory Panel. The Commission should ensure that the policy is implemented and followed.***
ISAC'S RESPONSE	**#8 The Illinois Student Assistance Commission accepts this Recommendation.** A new conflicts of interest policy will be presented to the Commission Board at its June 2012 meeting that will include appropriate disclosure requirements of potential conflicts of interest prior to procurement evaluation. The revised policy will also include investment restrictions related to potential or recent investments for any ISAC employee involved in the investment process as well as members of the Commission Board or Investment Advisory Panel. ISAC, through its Compliance Officer, will ensure that the policy is implemented and followed.

INVESTING FUNDS

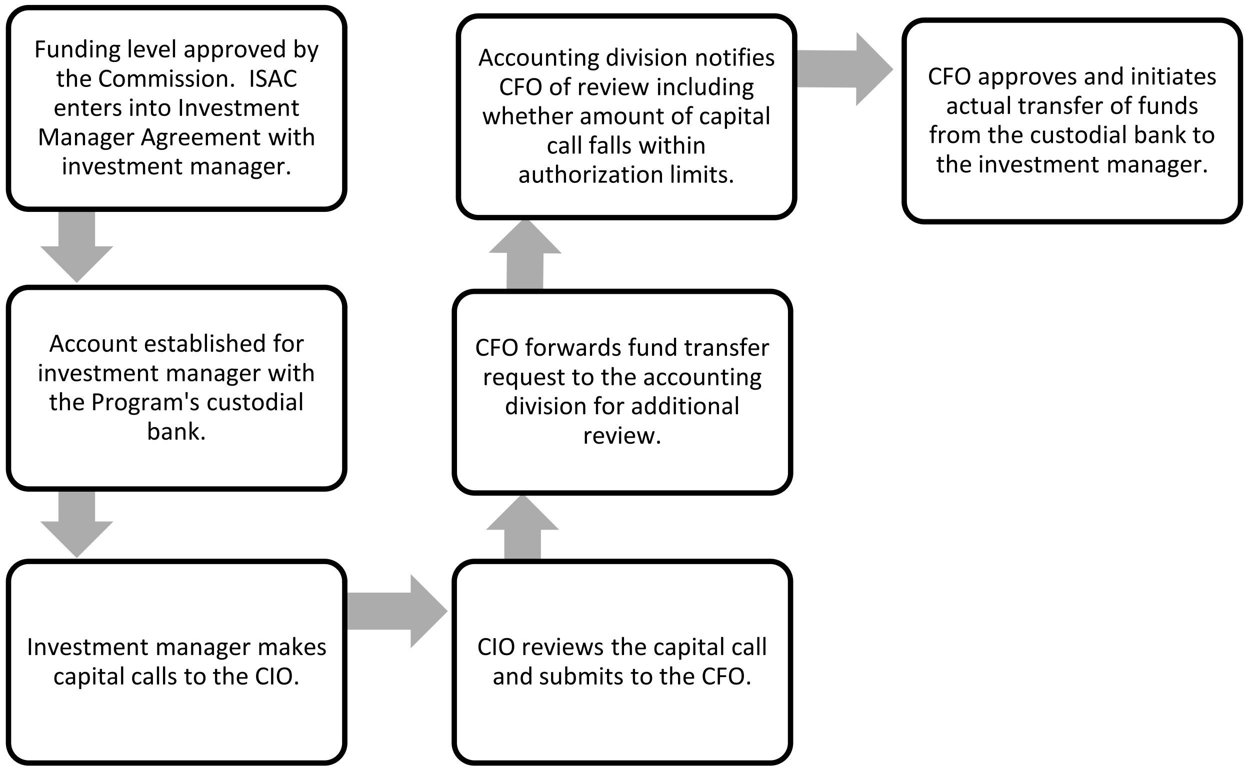
In examining investment manager files, we noted one investment manager that was provided funding that exceeded the amount authorized by $10 million. We also noted that a private equity investment of $14 million was made with a single company despite several risks outlined in the Subscription Agreement.

Investment Process

Investment managers are selected through the procurement process and approved by the Commission. Once selected, the Commission also approves funding levels. Funding is generally approved with wording such as: "...in no event shall the amounts invested in the Fund exceed $55,000,000." Investment managers do not always receive the entire amount authorized and many of the investment managers selected do not receive funding.

For most alternative investments, once the level of funding is approved, investment managers request funds in the form of capital calls. Capital calls include funding for specific investments, organizational expenses, and management fees. A written capital call is sent from the investment manager to the Chief Investment Officer (CIO). The CIO reviews the capital call and sends a request for a transfer of funds to the Chief Financial Officer (CFO). Fund requests are reviewed by the Accounting Division to ensure that requested amounts fall within the authorization limits. If the request falls within the limits, the CFO prepares a fund transfer request which is sent to the Program's custodial bank. This process is shown in Exhibit 2-7.

Exhibit 2-7
PROCESS FOR INVESTING FUNDS – ALTERNATIVE INVESTMENTS



Source: OAG analysis of College Illinois investment process.

These procedures are outlined in a policy that was effective June 4, 2011. Prior to this policy, the transfer request came straight from the Chief Investment Officer to the custodial bank. This resulted in one investment manager receiving more funds than were authorized by the Commission.

Reynoso Funding Authorization Level Exceeded

At its January 22, 2010 meeting, the Commission authorized up to $10 million in funding to Reynoso Asset Management. On May 25, 2010, the entire authorized amount of $10 million was transferred to Reynoso.

On October 6, 2010, ISAC's Chief Investment Officer directed the custodial bank to transfer an additional $10 million to Reynoso. This additional transfer exceeded the amount authorized by the Commission. ISAC realized the error and on December 17, 2010, directed the custodial bank to transfer $10 million back from the Reynoso account.

At its February 9, 2011 meeting, the Commission authorized an additional investment to Reynoso of $15 million bringing the authorized total to $25 million. There was no mention by ISAC staff during the Commission meeting of the mistaken transfer that exceeded the authorization amount. On February 15, 2011, the CIO directed the custodial bank to transfer $10 million back to Reynoso.

Direct Private Equity Investments

In April 2011, the Commission passed a resolution prohibiting direct private equity investments. This was less than two months after approving $10 million of additional funding for a similar private equity investment totaling $14 million.

In 2008, the Commission authorized a direct private equity investment of $12.7 million in ShoreBank. The Investment Policy was changed to allow this investment. By the end of fiscal year 2010, the Commission determined the entire $12.7 million value of the investment was worthless when the bank was taken over by the Federal Deposit Insurance Corporation (FDIC). At its April 1, 2011 meeting, the Commission adopted a resolution that stated that the Commission:

> *"...revise its investment policy to no longer allow Fund assets to be invested in any direct private equity investment, and that until such time as the investment policy is revised, the Commission shall not invest Fund assets in a direct private equity investment."*

The Executive Director stated at the meeting that this was intended to prohibit investments where there is not a fiduciary that lies between ISAC and the user of the capital. However, this was not clearly specified in the resolution.

Just two months prior to this, the Commission approved a private equity investment through one of its private equity investment managers. This investment is described below.

Private Equity Investment

At its June 26, 2009 meeting, the Commission approved the selection of seven investment managers under the private equity asset class including Camelot Acquisitions Secondary Opportunities. Funding not to exceed $15 million was authorized at the Commission's January 22, 2010 meeting.

Beginning in February 2010 through September 2010, Camelot issued four capital calls totaling $415,660 for organizational expenses and management fees. Subsequently, on October 14, 2010, Camelot requested capital in the amount of $5,007,643 to invest in a portfolio of direct investments.

On December 29, 2010, the Executive Director and the Chief Investment Officer, along with the managing director of Camelot, signed a resolution that amended the partnership agreement. The amendment allowed a greater percentage investment in a single company. Specifically, the resolution mentioned an investment in Fisker Automotive, a company that designs, manufactures, and distributes luxury plug-in hybrid vehicles. On January 3, 2011, Camelot requested capital in the amount of $4,045,856 for an investment in Fisker Automotive and for quarterly management fees.

On February 9, 2011, the Commission approved additional funding for Camelot for up to $10 million. The approval was actually for a separate fund called the CASO Co-Invest Fund which was managed by Camelot. That same day, Camelot issued a capital call of $10 million to invest directly in Fisker Automotive. Together with the previous capital call, the College Illinois Program has $14 million invested in a single company.

The subscription documents for the investment in Fisker Automotive contained a section on risk factors which included the following:

- **Concentration of Investment in Single Portfolio Company –** Concentration in a single investment involves risks greater than those generally associated with diversified acquisition funds.
- **No Assurance of Investment Return –** The Company cannot provide assurances that it will be able realize its investment in the Portfolio Company, or that it will be able to generate returns, if any, for its investors. An investment in the Company should only be considered by persons who can afford a loss of their entire investment.
- **High Risk Investment/Short Operating History –** Investment by the Company in the Portfolio Company may involve a high degree of risk in that the Portfolio Company is in a relatively early stage of development with little operating history and with a need for substantial additional capital to support expansion or to achieve or maintain a competitive position.
- **Illiquid and Long-Term Investment in Portfolio Company –** There is no liquidity of the Company's investment prior to the time that realization is achieved. It is, therefore, likely that no significant return from the disposition of the Company's investment will occur until at least three and possibly ten or more years from the date of closing of the transactions contemplated by the Subscription Agreement.

DIRECT PRIVATE EQUITY INVESTMENTS	
RECOMMENDATION NUMBER **9**	***The Illinois Student Assistance Commission should revise its Investment Policy to clarify its position on direct private equity investments and similar private equity investments where a substantial amount of funds is invested in a single company.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval will be revised to clarify ISAC's policy on direct private equity investments.

Chapter Three
PROGRAM ADMINISTRATION

CHAPTER CONCLUSIONS

The number of employees working for the College Illinois Program increased significantly over the six year period. Twelve of the 20 employees hired during that time period were principal administrative appointments which are positions hired at the discretion of the Executive Director. Two of the positions created were investment positions for which it was not clear what duties and responsibilities were performed. Both of these positions have subsequently been eliminated.

Other testing results showed that 46 percent (11 of 24) of the employees tested lacked position descriptions that listed the education and experience needed for the positions making it impossible to determine if employees were qualified. Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated.

One employee, the Director of Portfolio Management, voluntarily resigned his position effective July 21, 2010. Five days later, on July 26, 2010, the Executive Director of the Illinois Student Assistance Commission (ISAC) signed a voluntary separation agreement with the Director of Portfolio Management that included a lump sum payment of $24,166.

The annual report, which includes the actuarial report, is one of the primary vehicles for presenting meaningful information on the College Illinois Program. While the reports contain the minimal required statutory information, they do not contain further information required by the Investment Policy. The reports also do not contain certain information that would be useful to contract holders and others who are evaluating the Program.

ISAC is responsible for the actuarial assumptions used in both the actuarial report and to set tuition contract prices. **ISAC, however, was unable to provide documentation for how certain assumptions were established or any rationale to support the assumptions used.**

- The investment return assumption of 9.25 percent, which was used in the fiscal year 2010 report, was lowered to 7.50 percent in the fiscal year 2011 report. The lowering of the investment assumption coincided with the change in administration at ISAC.

- Beginning in 2008 the assumption for future contract sales was set at 5,000 new contracts with the amount increasing by 500 per year capping at 15,000 new contracts per year. Based on historical sales, this appears to have been an unrealistic assumption.

- The fiscal year 2010 actuarial report adopted an alternative approach that amortized investment gains and losses over a five year period. This change decreased the actuarial deficit of the Program. The fiscal year 2011 actuarial report, which was done by a new actuary, reverted to the traditional method. The actuary stated that this

> "smoothing" method "... is not commonly used as an actuarial assumption for prepaid tuition programs but is used more readily in pension investment programs."

The first two years of the Program showed an actuarial reserve and funded ratio greater than 100 percent. The last 11 years, however, have all shown an actuarial deficit. In fiscal year 2002, the funded ratio had gone down to 81.2 percent before rebounding to 93.3 percent in fiscal year 2007. The funded ratio fell dramatically over the next two fiscal years to a low of 67.6 percent in fiscal year 2009. The most recent actuarial report showed a funded ratio of 70.5 percent.

Contract sales have declined over the last six years from a high of 4,972 contracts in 2005-2006 to a low of 999 contracts in the most recent enrollment period. Recently, cancellations have outpaced sales with 1,523 cancellations in fiscal year 2011 and 778 cancellations during the first six months of fiscal year 2012. As of March 2012, the Program was closed to new enrollees.

INTRODUCTION

House Resolution Number 174 directed us to examine the efficacy of the Program's administration and, in particular, ISAC's oversight and administrative capacity to evaluate and direct College Illinois investments. The previous chapter focused on investments. This chapter focuses on other issues in program administration.

PERSONNEL TESTING

The number of employees working for the College Illinois Program increased significantly over the six year period. Twelve of the 20 employees hired during that time period were principal administrative appointments which are positions hired at the discretion of the Executive Director. Two of the positions created were investment positions for which it was not clear what duties and responsibilities were performed. Both of these positions have subsequently been eliminated.

Other testing results showed that 46 percent (11 of 24) of the employees tested lacked position descriptions that listed the education and experience needed for the positions making it impossible to determine if employees were qualified. Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated.

Hiring Issues

In fiscal year 2006, the College Illinois Program had four long standing employees which included the Director of the College Illinois Program. As shown in Exhibit 3-1, the number of employees working for College Illinois significantly increased over the next few years.

There are two classifications of employees at ISAC: civil service employees and principal administrative appointments. Civil service employees are hired based on qualifications specified through the civil service system. Conversely, principal administrative appointments follow a hiring process similar to the private sector.

Exhibit 3-1
COLLEGE ILLINOIS EMPLOYEES

Fiscal Year	Number of Employees	FTE[1]
2006	4	4.0
2007	4	4.0
2008	6	5.3
2009	12	8.0
2010	17	12.0
2011	19	11.5

[1]FTE is full time equivalent employees and was calculated based on the number of pay periods an employee's salary was charged to the Program.

Source: OAG analysis of direct payroll data.

According to an ISAC official, if a new position is needed, Human Resources staff meet with the hiring manager to determine the type of position and duties involved. It is then determined if the position is a civil service position or a principal administrative appointment. If it is a principal administrative appointment, a salary level is determined and an interview process created. The ISAC official noted that the Executive Director has the authority to make a principal administrative appointment without following these procedures.

We tested 24 employees whose salaries were charged as direct payroll expense to the College Illinois Program during fiscal years 2006 through 2011. Of these 24 employees, 20 were hired during the six-year period. Of the 20 employees hired, 12 (60%) were principal administrative appointments. Starting salaries of employees hired ranged from $50,000 to $140,000.

Many of the employees hired were in the Marketing and Communications division. This was part of a movement to bring more of the marketing effort in-house instead of through a contractor. As of August 2011, only one of the marketing personnel remained with College Illinois.

Investment Personnel

The three highest paid individuals were hired in the area of investments. All of the positions were newly created positions and all were principal administrative appointments. The positions were:

- Chief Investment Officer – starting salary of $140,000.

- Director of Portfolio Management and Direct Investment – starting salary of $140,000.

- Director of Beta Management – starting salary of $100,000.

None of the individuals initially hired in these three positions remain with the Program. We questioned the need for two of the positions – the Director of Portfolio Management and the Director of Beta Management – both of which have been subsequently eliminated. We noted several issues which are described below.

- All three of the positions lacked a position description that would list the education and experience required for the position. Therefore, we were unable to determine if the individuals hired met the qualifications.

  All of the individuals had several years of experience in the area of investments. However, the individual hired as the Director of Beta Management possessed only a two-year liberal arts degree. He was referred to the Program by the Director of Portfolio Management to whom he subsequently reported. Much of the Director of Beta Management's experience was working in firms that were run by the Director of Portfolio Management or where the Director of Portfolio Management was his immediate supervisor. Immediately prior to being hired as the Director of Beta Management, the individual was the general manager for a cast stone company which subsequently went out of business.

- **The Chief Investment Officer**, hired in May 2008, was the first of the three investment positions hired. The two subsequent investment employees, however, did not report to the Chief Investment Officer. The Director of Portfolio Management reported to the Executive Director. The Director of Beta Management reported to the Director of Portfolio Management.

  According to the Chief Investment Officer, in November 2010, he was asked to resign his position over a dispute involving the selection of an investment manager. The Chief Investment Officer said that a voluntary separation agreement was drafted and he was pressured to sign it. On January 21, 2011 (resignation date), the Chief Investment Officer signed the voluntary separation agreement effectively removing him from the position of Chief Investment Officer. However, the agreement specified that he would remain with ISAC and be paid through June 30, 2011 (separation date). If he was unable to secure non-ISAC employment prior to the separation date, the Chief Investment Officer was entitled to a lump sum payment equivalent to four months of salary. During this time, his salary continued to be charged to College Illinois.

  On May 13, 2011, the individual was re-assigned to a new position titled Director of IDAPP (Illinois Designated Account Purchase Program) and Chief Credit Officer. This was a principal administrative appointment position that was to continue through June 30, 2012, at an annual salary of $150,000. Despite his new position in a different program, his salary continued to be charged to College Illinois through June 30, 2011.

  Following the change in administration at ISAC, the position of Director of IDAPP and Chief Credit Officer was eliminated effective July 29, 2011. The individual received a lump sum payment of $48,332 which was equivalent to four month's salary as was specified in his appointment letter. This amount was not charged to the College Illinois Program as he was no longer working for College Illinois.

- **The Director of Portfolio Management** was hired in February 2009 at a salary of $140,000. His application listed the Executive Director as referring him for the position. The Investment Policy was revised in June 2009 and included a definition for the Director of Portfolio Management. The Policy stated that the Director of Portfolio Management "...shall have the duties and responsibilities with respect to the Program and the Fund set forth in this Policy." However, the only duty outlined in the Policy was to be a member of the Portfolio Committee. No other duties were specified.

  On July 21, 2010, the Director of Portfolio Management voluntarily resigned his position effective that same day. Five days later, on July 26, 2010, the Executive Director signed a voluntary separation agreement with the Director of Portfolio Management that included a lump sum payment of $24,166. **In effect, although he voluntarily resigned, the Director of Portfolio Management was paid a bonus of over $24,000. This payment was charged to the College Illinois Program.**

- **The Director of Beta Management** was hired in January 2010, at a salary of $100,000, to begin the Beta Management Program which was to utilize option based portfolio strategies. However, the Beta Management Program was never initialized. Despite this, the individual was given a raise to $110,000 on July 1, 2010. In May 2011, he was named the Interim Chief Investment Officer at a salary of $120,000. Since the Beta Management Program was never implemented, it is unclear what regular duties this individual performed from January 2010 through May of 2011.

  Following the change in administration at ISAC, on July 8, 2011, the individual was given 60 days notice of termination. His last day was July 8 but he continued to be paid for the 60 days which ended September 6, 2011. These salary payments continued to be charged to the College Illinois Program.

Other Testing Results

Results of testing showed that many of the personnel tested lacked position descriptions making it impossible to determine whether the individuals met the education and experience requirements for the positions. For those that had position descriptions, we determined that one individual did not meet the education and experience requirements for that position. In addition, several positions did not relate directly to the College Illinois Program and several employees received payments at termination.

Position Descriptions

We examined personnel files to determine if employees were qualified for the positions held. **Personnel files for 46 percent (11 of 24) of the employees tested lacked position descriptions.** Position descriptions typically outline the duties to be performed as well as the educational and experience requirements for the position. Without positions descriptions, we were unable to determine if those employees met the education and experience requirements for the positions.

For the remaining 13 employees tested, only 1 did not meet the position requirements. This position was a sales and marketing position that required a business degree and five years of experience. The candidate, hired in October 2008, had an English degree and two years experience.

Positions Not Directly Related to the College Illinois Program

The 24 positions tested were all employees whose salaries were charged directly to the College Illinois Program. To assess the appropriateness of salaries being charged to College Illinois, we examined personnel files to determine whether the positions related directly to the Program. **For 8 of the 24 employees examined (33%), position descriptions and other information in the file indicated that the positions did not relate directly to the College Illinois Program. Salaries and benefits charged as a direct payroll expense for these eight employees totaled $613,000 and should not have been charged as a direct payroll expense.** This is discussed in more detail in Chapter Four.

Payments at Termination

Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated. This only includes employees whose salaries were charged directly to the College Illinois Program and therefore does not include the former Executive Director. He was paid $98,000 as part of a separation agreement ending his employment in July 2011.

Exhibit 3-2 shows the amounts paid to the eight employees. Most of the payments were due to terms outlined in appointment letters. Typically, the appointment letters for principal administrative appointments contained a clause stating that the appointment may be terminated by either party with 60 days notice. Five of the eight who received payments were paid either a lump sum equivalent of 60 days pay or were paid for an additional 60 days upon notification of termination.

Exhibit 3-2
PAYMENTS TO EMPLOYEES RESIGNING OR TERMINATED

Employee	Payment Resulting From	Amount Paid
1	60 day notice	$18,334
2	60 day notice	13,334
3	60 day notice	11,668
4	60 day notice	10,834
5	60 day notice	10,834
6	Appointment letter	48,332
7	Separation agreement	24,166
8	Severance agreement and 60 day notice	38,501
	Total paid	$176,003

Note: Amounts for 60 day notices were estimated at two months' salary.

Source: OAG analysis of personnel and payroll records.

As mentioned previously, one employee, the former Chief Investment Officer was paid $48,332, the equivalent of four months' salary which was specified in an appointment letter.

Another employee, the Director of Portfolio Management was paid $24,166 as part of a separation agreement that was entered into after he resigned. This was also described in more detail in the previous section, Investment Personnel.

Similarly, another employee was paid $28,500 per a severance agreement entered after she resigned. The employee was acting as the Director of Sales and Marketing at a salary of $82,000. On August 15, 2008, due to changing agency needs, she was offered a new appointment with the title of Manager, Sales and Marketing at a salary of $70,000. The same day as the offer, she declined the offer and gave 60 days notice of resignation. Three days later she signed a severance agreement that included a lump sum payment of $28,500. Her last day was August 29, 2008, but she continued to be paid through October 15, 2008, for a total payout of $38,501.

Seven of the eight payments shown in Exhibit 3-2 were charged to the College Illinois Program for an amount totaling $127,671. **This translates to $127,671 less in funds to be invested with the Program, funds which will ultimately be used to pay tuition for contract holders.**

<table>
<tr><th colspan="2">PERSONNEL</th></tr>
<tr><td>RECOMMENDATION NUMBER
10</td><td>The Illinois Student Assistance Commission should:
• ensure that all positions contain position descriptions that outline the education and experience needed for the position;
• ensure that only the salaries for employees whose work relates directly to the Program are charged as a direct payroll expense; and
• examine its practice of making additional payments to employees at the end of their employment.</td></tr>
<tr><td>ISAC'S RESPONSE</td><td>The Illinois Student Assistance Commission accepts this Recommendation. ISAC has initiated a comprehensive review to ensure that all current and future position descriptions for College Illinois! employees clearly explain the duties, education, and professional experience required for the position. Additionally, ISAC will clearly document the duties performed by all employees whose work relates directly to the Program and are charged as direct payroll expenses. The agency will examine its terms and conditions of employment going forward.</td></tr>
</table>

ANNUAL REPORTS

The annual report, which includes the actuarial report, is one of the primary vehicles for presenting meaningful information on the College Illinois Program. **While the reports contain the minimal required statutory information, they do not contain further information required by the Investment Policy.** The reports also do not contain certain information that would be useful to contract holders and others who are evaluating the Program. For example:

- While they contain a one-page program overview, the reports do not have any type of management discussion and analysis of the Program.

- The reports do not contain historical comparisons such as contract sales year by year, investment return year by year, or actuarial deficit year by year. The reports also do not contain any information on contract cancellations.

- The reports contain minimal information on the users of the Program. Useful information could include information on the number of prepaid students using benefits each year, the colleges and universities where those benefits are being utilized, and the average paid at each institution. This could also be presented historically to show trends in the Program.

- The actuarial reports, which are part of the annual reports, did not contain any comparison of assumptions used to what actually occurred. The actuarial reports also did not contain a historical comparison of assumptions and how they have changed over time. Actuarial reports will be discussed in more detail in the next section.

Required Information

The Illinois Prepaid Tuition Act requires ISAC to prepare an annual report. The Act states:

> *The Commission shall annually prepare or cause to be prepared a report setting forth in appropriate detail an accounting of all Illinois prepaid tuition program funds and a description of the financial condition of the program at the close of each fiscal year. Included in this report shall be an evaluation by at least one nationally recognized actuary of the financial viability of the program. This report shall be submitted to the Governor, the President of the Senate, the Speaker of the House of Representatives, the Auditor General, and the Board of Higher Education on or before March 1 of the subsequent fiscal year. This report also shall be made available to purchasers of Illinois prepaid tuition contracts and shall contain complete Illinois prepaid tuition contract sales information, including, but not limited to, projected postsecondary enrollment data for qualified beneficiaries.* (110 ILCS 979/30(d))

The College Illinois Statement of Investment Policy imposes further requirements for the annual report. The Policy states the Commission is responsible for producing an annual report covering the following subjects:

- Investment performance summary including comparisons to benchmarks;
- Current and historical asset allocation in the Program;
- Progress toward the stated performance objectives in the Policy; and
- Other pertinent matters.

The reports reviewed met the statutory requirements. However, the reports do not meet the requirements outlined in the Investment Policy. Specifically:

- **The reports do not contain an investment performance summary and do not contain comparisons to benchmarks.**
- **The reports contain the current year's asset allocation but do not contain historical asset allocations.**
- **The reports do not contain information on progress toward the stated performance objectives in the Policy.**

Report Content Compared to Other States' Annual Reports

The College Illinois annual reports were consistent in their content with each containing the following information:

- A one-page cover letter;
- A one-page list of the members of the Commission;
- A one-page list of the members of the Investment Advisory Panel;
- A one-page program overview;
- The Financial Audit conducted by our Office; and
- The Actuarial Report.

Annual reports for other states we examined contained this same basic information. However, other states' reports also contained additional types of information that would be useful to contract holders and others who are evaluating the Program. For example:

- Florida's annual report contained 10 pages of additional information. This included information that might be included in an enrollment brochure, such as testimonials and frequently asked questions. It also contained useful information, such as contract sales each year since inception, a cumulative total of customers by county, a breakdown of where prepaid students attended school, and demographics for account holders and students.

- Virginia's annual report contained 14 pages of management discussion and analysis which included financial highlights for the previous year, the number of payments and funds distributed each year, and economic factors and outlook.

- Washington's annual report was only six pages long but contained information on enrollment growth since inception, a breakdown of where prepaid students attended school, growth of assets under management over the last ten years, and legislative action involving the program.

ANNUAL REPORT	
RECOMMENDATION NUMBER 11	***The Illinois Student Assistance Commission should ensure that its annual report contains all information required by its Investment Policy. ISAC should also include additional information that would be useful to contract holders and others who are evaluating the Program.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. As noted in the report, ISAC complies with all statutory requirements in the current form of the annual report. That said, the agency believes that increasing program transparency and the amount of information shared with current contract holders and future purchasers of College Illinois! contracts is vital in rebuilding and maintaining confidence in the Program. The agency has begun to post additional information, and on a more frequent basis, to both its primary websites: 529prepaidtuition.org and isac.org. ISAC is examining what other prepaid programs include in their annual reports with the intention of providing more information about contract sales, cancellations, tuition changes, schools beneficiaries are attending and more robust discussion of investment performance.

ACTUARIAL REPORTS

ISAC, which is responsible for the actuarial assumptions used in both the actuarial report and to set tuition contract prices, was unable to provide documentation for how assumptions were established. The investment return assumption of 9.25 percent, which was used in the fiscal year 2010 report, was lowered to 7.50 percent in the fiscal year 2011 report. The lowering of the investment assumption coincided with the change in administration at ISAC.

Beginning in 2008 the assumption for future contract sales was set at 5,000 new contracts with the amount increasing by 500 per year capping at 15,000 new contracts per year. Based on historical sales, this appears to have been an unrealistic assumption.

The fiscal year 2010 actuarial report adopted an alternative approach that amortized investment gains and losses over a five year period. This change decreased the actuarial deficit of the Program. The fiscal year 2011 actuarial report, which was done by a new actuary, reverted to the traditional method. The actuary stated that this "smoothing" method "... is not commonly used as an actuarial assumption for prepaid tuition programs but is used more readily in pension investment programs.”

Actuarial Assumptions

The Illinois Prepaid Tuition Act requires that the annual report include “...an evaluation by at least one nationally recognized actuary of the financial viability of the program.” For each fiscal year since the inception of the Program, beginning in fiscal year 1999, College Illinois has used an actuary to provide a determination of the soundness of the Program. The purpose of the valuation is to compare the value of the assets of the Program to the value of the expected future benefits and expenses of the Program.

The actuarial report makes two important points:

- The valuation results were based upon data and information furnished by ISAC; and
- The major actuarial assumptions used in the analysis were by provided by and are the responsibility of ISAC.

ISAC, however, was unable to provide documentation for how certain assumptions were established or any rationale to support the assumptions used. We examined the actuarial reports for fiscal years 2006 through 2011 and examined the assumptions used. We focused on three primary factors: investment return, tuition increases, and future contract sales. Exhibit 3-3 shows the assumptions used in the actuarial reports for these three factors.

Exhibit 3-3
ACTUARIAL REPORT ASSUMPTIONS

Report Fiscal Year	Assumptions Used: Investment Return	Tuition Increases – Public Universities	Future Contract Sales
2005	7.75% per year	9.0 % for 2006 7.5% thereafter	5,000 – 6,000 per year
2006	8% per year	9.75% for 2007 7.75% thereafter	5,000 per year
2007	8.25% for 2008 8.50% for 2009 8.75% for 2010 9.00% thereafter	11.00% for 2008 7.75% thereafter	4,500 per year
2008	8.50% for 2009 8.75% for 2010 9.00% thereafter	10.00% for 2009 9.00% for 2010 8.00% thereafter	5,000 for next enrollment period Increasing by 500 each year, capping at 15,000 per year
2009	9.25% for 2010 8.75% thereafter	Legacy contracts: 9.00% for 2010 8.00% thereafter University contracts: 8.50% for 2010 7.50% thereafter University Plus contracts: 9.50% for 2010 8.50% thereafter	5,500 for next enrollment period Increasing by 500 each year, capping at 15,000 per year
2010	9.25% for 2011 8.75% thereafter	Legacy contracts: 8.00% per year University contracts: 7.50% per year University Plus contracts: 8.50% per year	3,500 for next enrollment period Increasing by 500 each year, capping at 15,000 per year
2011	7.5% per year	Legacy contracts: 8.00% per year University contracts: 7.50% per year University Plus contracts: 8.50% per year	2,500 per year

Note: In 2009, tuition increase assumptions were changed to account for the different types of contracts available for purchase.

Source: OAG analysis of actuarial reports.

Investment Return Assumption

The investment return assumption increased from 8 percent in the fiscal year 2006 report to 9.25 percent in the fiscal year 2010 report. The fiscal year 2011 report lowered the investment return assumption to 7.5 percent.

The lowering of the investment assumption coincided with the change in administration at ISAC. We asked, based on the change in assumptions, whether ISAC considered the assumption used in the previous reports to be unrealistic. Officials responded that ISAC believes those prior return assumptions were realistic, albeit within the high end of a realistic band of assumptions.

Exhibit 3-4 shows the assumed rate of return used in the actuarial report each year beginning with the fiscal year 2005 report. For example, for the fiscal year 2007 report, the exhibit shows that a return of 8.25 percent was used for fiscal year 2008 and increased for the next three years.

Exhibit 3-4
ACTUARIAL ASSUMED RATE OF RETURN VS. ACTUAL RETURN

	FY06	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**
FY05 Report Assumptions	7.75%	7.75%	7.75%	7.75%	7.75%	7.75%	7.75%
FY06 Report Assumptions		8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
FY07 Report Assumptions			8.25%	8.50%	8.75%	9.00%	9.00%
FY08 Report Assumptions				8.50%	8.75%	9.00%	9.00%
FY09 Report Assumptions					9.25%	8.75%	8.75%
FY10 Report Assumptions						9.25%	8.75%
FY11 Report Assumptions							7.50%
Actual Annualized Return	7.6%	15.4%	(7.7%)	(15.1%)	9.7%	16.1%	-
5-year Annualized Return	5.6%	9.3%	7.1%	1.2%	0.8%	2.9%	-

Source: College Illinois actuarial reports and investment reports.

Exhibit 3-4 also shows the actual return for each year as well as the 5-year return as of the end of each fiscal year. Actual returns have fluctuated dramatically over the last several years ranging from 16.1 percent in fiscal year 2011 to -15.1 percent in fiscal year 2009. **As of June 30, 2011, the total fund had an average return of 2.9 percent over the last five years and a return of 3.5 percent since the Program's inception in 1998. This compares to an actuarial assumed rate used in the 2006 – 2011 actuarial reports ranging between 7.5 percent and 9.25 percent.**

Tuition Increases Assumption

The assumption for tuition increases remained fairly consistent ranging between 7.5 percent and 11 percent depending on the type of contract. In the earlier years, a higher rate was assumed for the next year and lower rate for the following years. This changed in 2010 when a constant rate was used.

The other main change resulted from the different types of contracts offered. Beginning with the 2008-2009 enrollment period, the University option was changed to two different options. One option, called University Plus, was for semesters at only the University of Illinois at Urbana-Champaign. The other option was for semesters at all of the other public universities. The assumptions took these different types of contracts into account with a higher assumed rate for the University Plus option.

Exhibit 3-5 shows the weighted average for tuition and fees at Illinois public universities for the last 20 years. A weighted average is determined by adjusting the average tuition based on attendance at each school. Since the 2001-02 academic year, tuition and fee increases have increased by at least 8.6 percent in every year with a high of 13.5 percent in 2004-05.

Exhibit 3-5
HISTORIC INCREASES IN TUITION AND FEES AT ILLINOIS PUBLIC UNIVERSITIES (WEIGHTED AVERAGE)

Academic Year	Tuition and Fees	Annual Increase
1990-91	$2,410	
1991-92	2,538	5.3%
1992-93	2,901	14.3%
1993-94	3,134	8.0%
1994-95	3,303	5.4%
1995-96	3,434	4.0%
1996-97	3,629	5.7%
1997-98	3,817	5.2%
1998-99	3,942	3.3%
1999-00	4,160	5.5%
2000-01	4,406	5.9%
2001-02	4,786	8.6%
2002-03	5,298	10.7%
2003-04	5,785	9.2%
2004-05	6,565	13.5%
2005-06	7,151	8.9%
2006-07	7,875	10.1%
2007-08	8,553	8.6%
2008-09	9,452	10.5%
2009-10	10,442	10.5%
2010-11	11,386	9.0%

Source: Illinois Student Assistance Commission.

Future Contract Sales Assumption

The most dramatic change in assumptions occurred in the future contract sales. The first three years shown in Exhibit 3-3 assumed a constant per year number for contract sales. However, beginning in 2008 and for the following two years, the assumption was changed to an increasing amount of sales each year capping at 15,000 new contracts per year. Based on historical sales, this appears to have been an unrealistic assumption. In 2011, this was changed to a constant per year number of 2,500 per year.

Exhibit 3-6 compares the contract sales assumptions to the actual contract sales. Sales are discussed in more detail later in this Chapter.

Exhibit 3-6
ACTUARIAL ASSUMED CONTRACT SALES VS. ACTUAL CONTRACT SALES

	Enrollment Period						
	2005-2006	**2006-2007**	**2007-2008**	**2008-2009**	**2009-2010**	**2010-2011**	**2011-2012**
FY05 Report Assumptions	5,000-6,000	5,000-6,000	5,000-6,000	5,000-6,000	5,000-6,000	5,000-6,000	5,000-6,000
FY06 Report Assumptions		5,000	5,000	5,000	5,000	5,000	5,000
FY07 Report Assumptions			4,500	4,500	4,500	4,500	4,500
FY08 Report Assumptions				5,000	5,500	6,000	6,500
FY09 Report Assumptions					5,500	6,000	6,500
FY10 Report Assumptions						3,500	4,000
FY11 Report Assumptions							2,500
Actual Contract Sales	4,972	4,386	4,860	3,669	3,039	999	-

Source: College Illinois actuarial reports and contract sales information.

Setting Tuition Contract Prices

The actuarial projections play a big part in establishing the tuition contract prices. Each year, the Commission established the contract prices to charge for the next enrollment period. Prices were developed by staff in cooperation with the program's actuary. Recommended pricing was then submitted to the Commission for approval.

When considering approval of the proposed contract prices, the documentation provided to the Commission stated that when establishing contract prices, a number of different factors were considered including:

- Actuarial impact of tuition and fee increases;
- Impact of truth-in-tuition legislation;
- State budget constraints creating upward pressure on tuition and fees;
- Improving the actuarial soundness of the program;
- The projection of investment performance; and
- Anticipated annual contract sales.

For the most recent pricing period, this documentation consisted of a four-page discussion of the factors considered. **This is the only documentation that exists to support how the prices were established. There is no underlying analysis that would provide**

needed support for the level of contract pricing. For example, when discussing the investment return assumption for the 2010-2011 pricing period, the documentation stated:

> *Beginning with 2009-2010, expectations for future (gross) investment performance have increased to reflect the changes made to the investment policy: from 8.5 percent in FY2009; to 9.25 percent in FY2010 and FY 2011; and to 8.75 percent in each year thereafter. This enhanced investment performance is possible in part because of opportunities inherent in the portfolio's size (now nearly $1.0 billion) and flows from asset allocation changes and further diversification of the program's investment portfolio implemented in FY2010 and thereafter, actions endorsed earlier this year by both the program's Investment Advisory Panel and the Commission. Those actions include further diversification of the investment portfolio's allocation to other asset classes with lower correlations to domestic equities such as Real Estate, Private Equity, Infrastructure and Hedge Funds.*

This is the only documentation that exists for setting the investment return assumption. There is no underlying analysis to show how this percentage was determined or that would show if this was a reasonable assumption given the investment portfolio.

As another example, beginning in 2001, a stabilization reserve strategy was implemented. The stabilization reserve required that a premium be added to contract prices at least sufficient to eliminate the current actuarial deficit over a period of ten years. For example, for the 2005-2006 enrollment period, tuition and fees were projected to increase by an average of 9 percent at Illinois universities. However, contract prices were increased 14.7 percent.

When discussing the stabilization reserve for the 2010-2011 pricing period the documentation stated:

> *Continuation of the program's stabilization reserve requires that a premium be added to contract prices at least sufficient to eliminate the current actuarial deficit within a set time frame (15 years)....Prices have been set at a level that will provide revenue sufficient not only to fund future contract obligations and current administrative costs, but also to gradually reduce the program's current actuarial deficit.*

There is no indication of what the exact stabilization reserve was or how it affected the pricing level.

Tuition contract prices have increased significantly over the last six years. Exhibit 3-7 shows prices for the two most common options: eight semesters at a university and four semesters at a community college. In the 2005-2006 enrollment period, eight semesters could be purchased at a university for a lump sum price of $35,925 for the category Infant – Kindergarten. For the 2010-2011 enrollment period, this had increased to $93,184 for the University of Illinois at Urbana-Champaign, an increase of 159 percent. The increase for community colleges was not as dramatic. Four semesters for the category Infant – Kindergarten increased from $4,882 to $6,871, an increase of 41 percent.

Exhibit 3-7
COLLEGE ILLINOIS CONTRACT PRICES – LUMP SUM PAYMENT

Enrollment Period	University – 8 Semesters		
	Infant - Kindergarten	1st Grade - 8th Grade	9th Grade and Older
2005-2006 Enrollment	$35,925	$37,898	$39,571
2006-2007 Enrollment	$41,493	$43,773	$45,704
2007-2008 Enrollment	$42,323	$45,305	$48,675
2008-2009 Enrollment	$43,438 / $58,419	$45,626 / $61,360	$47,100 / $63,342
2009-2010 Enrollment	$49,988 / $74,547	$52,520 / $75,786	$54,220 / $76,363
2010-2011 Enrollment	$59,986 / $93,184	$63,024 / $94,733	$65,064 / $95,453

Enrollment Period	Community College – 4 Semesters		
	Infant - Kindergarten	1st Grade - 8th Grade	9th Grade and Older
2005-2006 Enrollment	$4,882	$5,125	$5,305
2006-2007 Enrollment	$5,224	$5,484	$5,676
2007-2008 Enrollment	$5,329	$5,594	$5,790
2008-2009 Enrollment	$5,725	$5,953	$6,103
2009-2010 Enrollment	$5,975	$6,338	$6,626
2010-2011 Enrollment	$6,871	$7,289	$7,620

Auditor Notes:

Beginning with the 2008-2009 enrollment period, the University option was changed to two different options. The more expensive option is for semesters at the University of Illinois at Urbana-Champaign. The less expensive option is for semesters at any of the other public universities.

Beginning with the 2009-2010 enrollment period, a year-round enrollment was offered with prices increasing each month. The exhibit uses prices from the month of May for each of these enrollment periods.

Source: OAG analysis of College Illinois contract pricing information.

As mentioned earlier, a stabilization reserve strategy was implemented in 2001. **However, this strategy was not followed for the 2007-2008 enrollment period.** Instead of the bigger price increases that were seen in previous years, that year's increase averaged only 4 percent for university contracts. This was despite an average tuition increase of 8.6 percent the previous year and a projected annual tuition inflation of 7.75 percent for future years. The reason given for the smaller price increase was as follows:

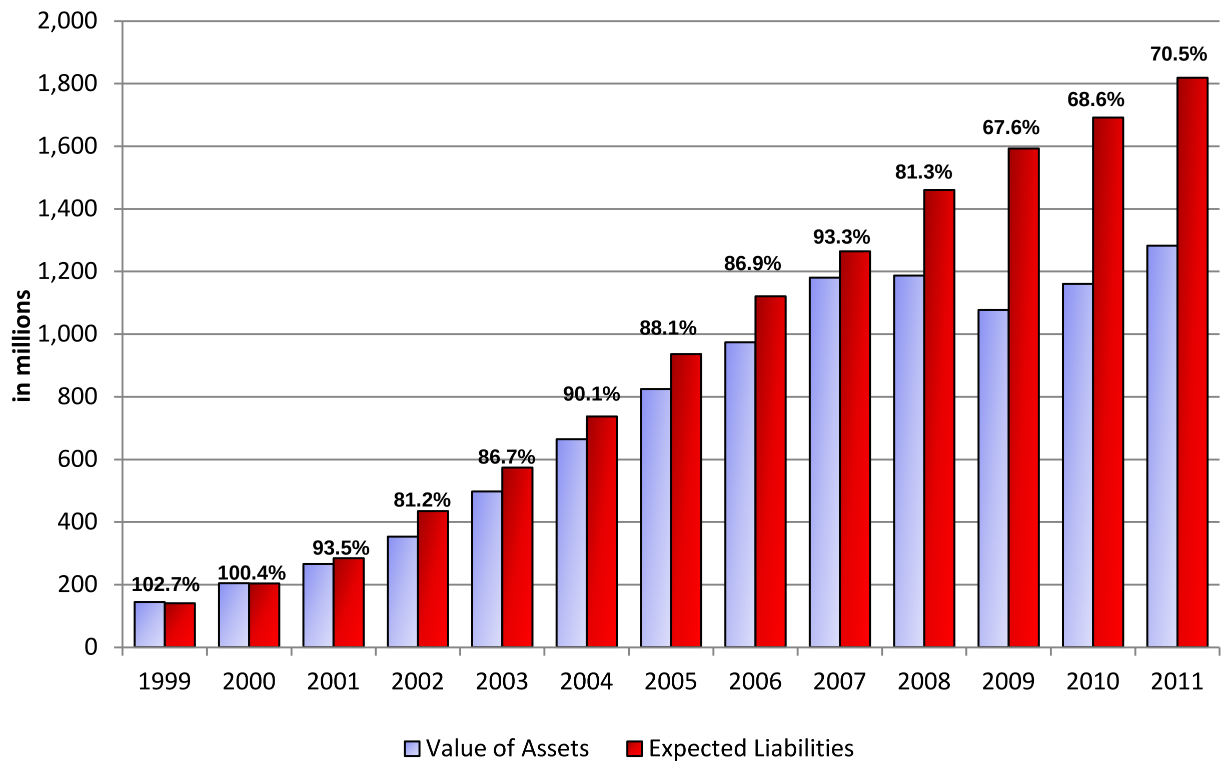
> *Contract prices can increase less than tuition increases primarily because recent changes to the program's investment policy will generate significantly higher investment performance over time. The exceedingly strong investment performance (i.e., 15.7 percent) recorded during FY2007 also had a positive impact upon recommended contract pricing.*

This strategy had a detrimental effect on the actuarial deficit as the Program's investment performance for fiscal year 2008 was -7.7 percent compared to the assumption of 8.25 percent.

Actuarial Soundness Valuation

The actuarial reports determined the estimated funded ratio of the Program. The valuation compares the value of the assets of the Program to the value of expected future tuition payments to beneficiaries. Exhibit 3-8 shows the value of assets compared to the expected liabilities as well as the funded ratio since the Program's inception.

Exhibit 3-8
FUNDED RATIO OF THE COLLEGE ILLINOIS PROGRAM
Fiscal Years 1999 – 2011



Note: The Value of Assets includes the present value of installment contract receivables.

Source: OAG analysis of actuarial reports.

The first two years of the Program showed an actuarial reserve and funded ratio greater than 100 percent. The last 11 years, however, have all shown an actuarial deficit. In fiscal year 2002, the funded ratio had gone down to 81.2 percent before rebounding to 93.3 percent in fiscal year 2007. The funded ratio fell dramatically over the next two fiscal years to a low of 67.6 percent in fiscal year 2009. The most recent actuarial report showed a funded ratio of 70.5 percent.

The fiscal year 2008 actuarial report contained a section called "Alternative Asset Valuation" which stated that, at the request of the Commission, an alternative asset calculation was performed for comparative purposes. This approach amortized investment gains and losses over a five year time frame. This alternative approach resulted in a funded ratio of 87.3 percent compared to 81.3 percent.

In the fiscal year 2009 report, this alternative method was shown again but more prominently by being mentioned on the first page of the report. The traditional method was still mentioned first. However, the fiscal year 2010 report adopted the alternative approach:

> *At the direction of the Board of the College Illinois! Prepaid Tuition Program, valuation assets are now calculated by amortizing investment gains and losses over a 5-year timeframe.*

This change decreased the actuarial deficit of the Program. Under the new method, the actuarial deficit was $340.9 million (funded ratio of 79.8%) compared to a deficit of $531.3 million (funded ratio of 68.6%) under the traditional method. The traditional method was barely mentioned in the report.

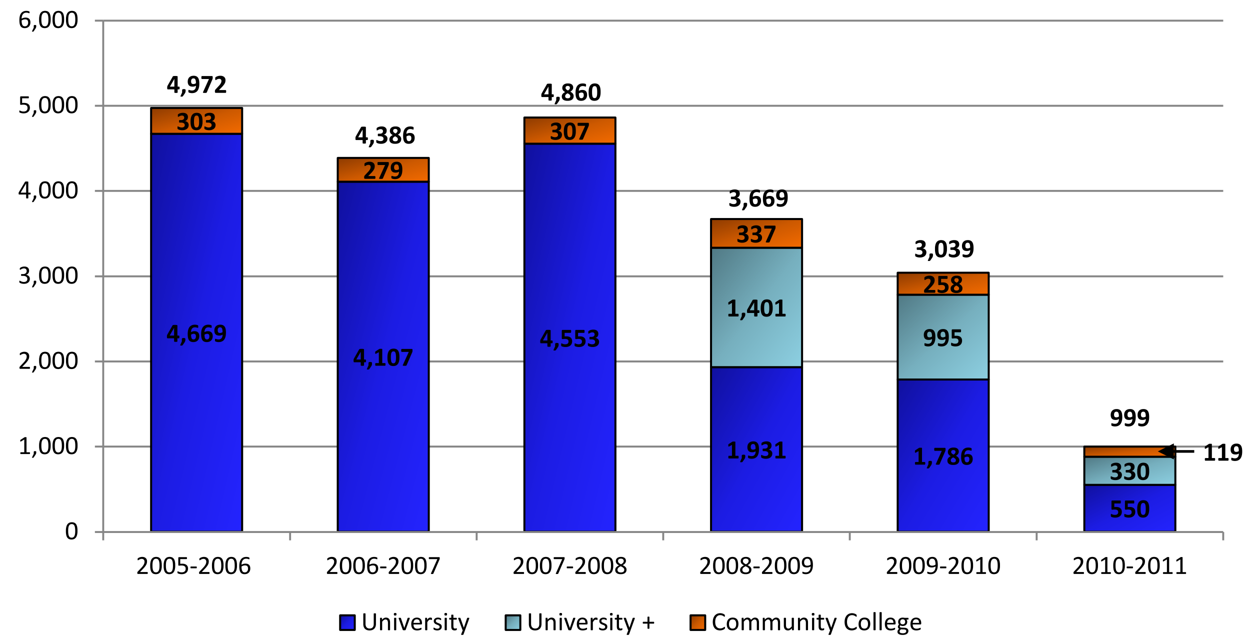
The fiscal year 2011 actuarial report, which was done by a new actuary, reverted to the traditional method. This report was done after the change in management at ISAC. The fiscal year 2011 report referred to the alternative method as a "smoothing" method. The "smoothing" method was discussed in the report but was not used in the projections. The actuary stated that the "smoothing" method "... is not commonly used as an actuarial assumption for prepaid tuition programs but is used more readily in pension investment programs."

ACTUARIAL REPORT ASSUMPTIONS	
RECOMMENDATION NUMBER 12	***The Illinois Student Assistance Commission should ensure that assumptions used in both the actuarial report and in setting contract prices are supported by documentation that shows how the assumptions were established.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. ISAC will fully document assumptions used and how they were derived both in the annual actuarial valuation soundness report and in setting contract pricing.

TUITION CONTRACT SALES AND CANCELLATIONS

Contract sales have declined over the last six years. Exhibit 3-9 shows contract sales for the last six enrollment periods. Sales have declined from a high of 4,972 contracts in 2005-2006 to a low of 999 contracts in the most recent enrollment period. As of March 2012, the Program was closed to new enrollees.

Exhibit 3-9
CONTRACT SALES
2005-2006 Enrollment Period through 2010-2011 Enrollment Period



Source: OAG analysis of College Illinois contract sales.

Cancellation Process

Purchasers who cancel a contract have the right to a refund. Contracts can be cancelled voluntarily, involuntarily, or as a result of fraud. When contracts are cancelled, ISAC assesses fees. The cancellation fees are shown in Chapter Four in Exhibit 4-1.

Voluntary Cancellation

A purchaser can terminate a tuition contract at any time and request a refund. In order to cancel a contract and receive a refund, ISAC must be provided with a written request from the purchaser. If the contract has been held for less than three years, an amount equal to all payments made less fees and charges shall be refunded. If the contract is more than three years old, purchasers who voluntarily cancel are entitled to receive the original purchase price of the contract plus two percent interest compounded annually calculated based on the number of unused credit hours on the contract.

Involuntary Cancellation

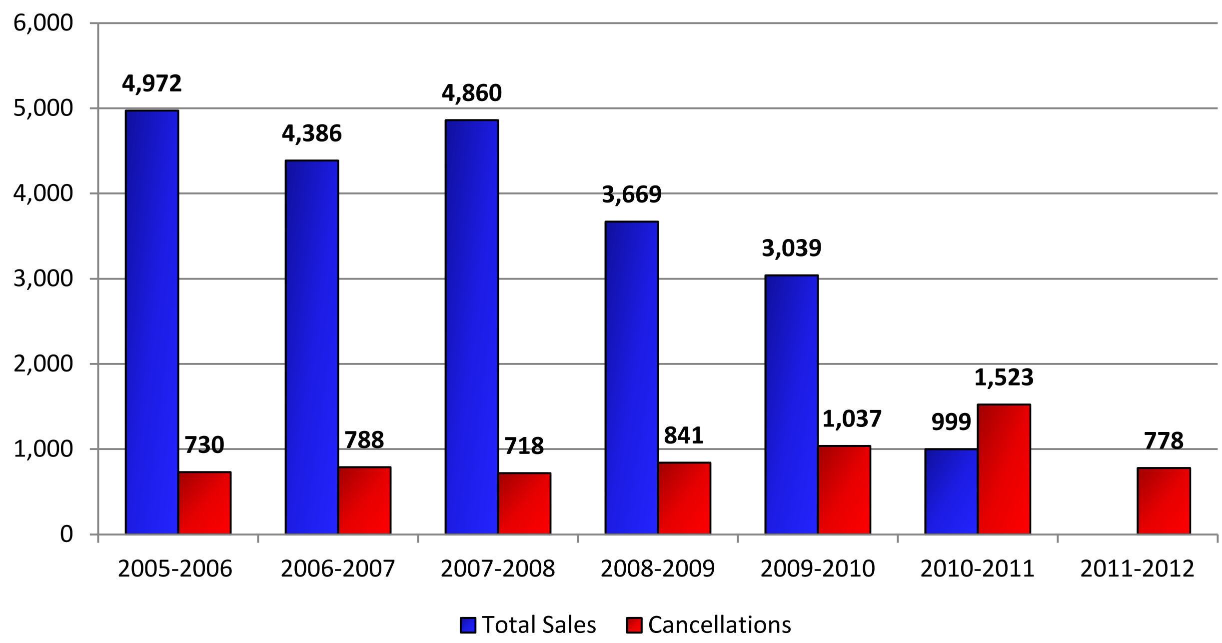
Involuntary cancellation occurs as the result of payment delinquency. Involuntary cancellations occur if an initial payment or subsequent payments are not made. Depending on when the contract was purchased, either a refund will be given, less fees and charges, or, if sufficient funding has been received, the contract is converted to a plan equal to the semester hours paid.

Fraud Cancellation

ISAC can cancel a contract as a result of deliberate misrepresentation. If ISAC makes this determination, the purchaser is entitled to a refund of payments made less applicable fees and service charges. Exhibit 3-11 shows the process involved for the different types of cancellations.

Exhibit 3-10 shows total contract sales compared to cancellations. While sales have declined, cancellations have increased. Recently, cancellations have outpaced sales with 1,523 cancellations in fiscal year 2011 and 778 cancellations during the first six months of fiscal year 2012. The November 18, 2011 meeting minutes indicated that the 2011-2012 enrollment period was being delayed in order to address the challenges facing the program. As of March 2012, the Program remained closed to new enrollees.

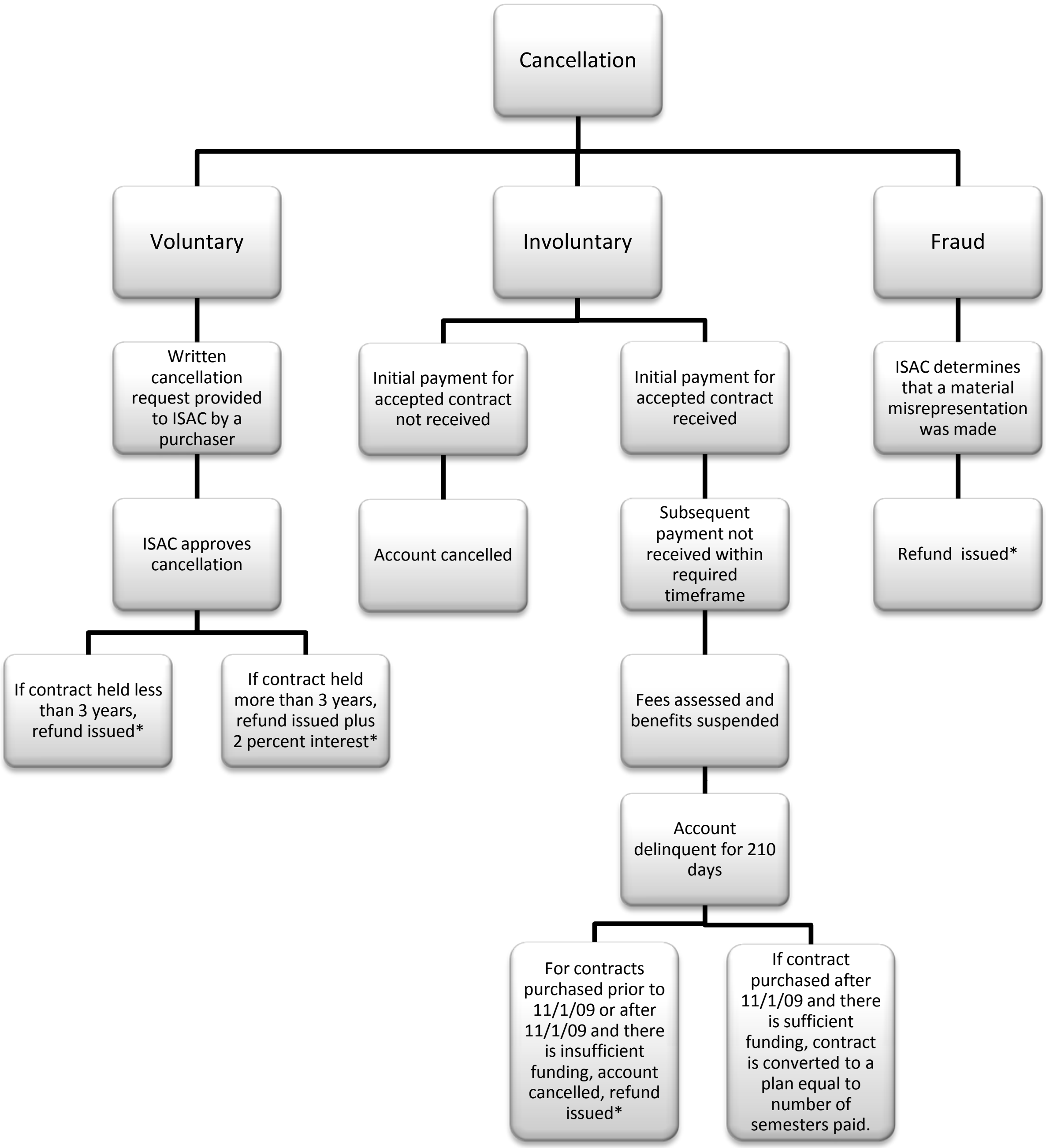
Exhibit 3-10
TOTAL SALES vs. CANCELLATIONS



Note: 2011-2012 cancellations are through December 31, 2011.

Source: OAG analysis of College Illinois contract sales and cancellations.

Exhibit 3-11
CANCELLATION PROCESS



* Refund issued for amount paid less any benefits used, refunds paid, and all fees and charges.

Source: OAG analysis of master agreements and administrative rules.

Chapter Four

PROGRAM COSTS

CHAPTER CONCLUSIONS

The cost of operating the College Illinois Program has risen dramatically over the last six years. Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011. There were several reasons for the increase in costs:

- Investment management fees have increased significantly from $2.5 million in fiscal year 2006 to $11.2 million in fiscal year 2011 because fees paid to managers of alternative investments have been substantially higher.

- Direct payroll expense more than tripled over the six year period increasing from $0.4 million in fiscal year 2006 to $1.36 million in fiscal year 2011. The primary reason direct payroll expense increased was that the number of employees working directly on the Program increased from 4 full time equivalent (FTE) employees in fiscal year 2006 to 11.5 FTE in fiscal year 2011. We questioned $613,000 in salaries and benefits for eight different employees charged as a direct payroll expense to the College Illinois Program because there was insufficient documentation to show how much, if any, of their duties pertained to the Program.

- Shared payroll expense, for ISAC employees that provide services to the Program but do not work directly for the Program, increased significantly over the six year period from $0.3 million in fiscal year 2006 to $1.9 million in fiscal year 2011.

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program. An administrative load fee was included as part of tuition contract prices. However, ISAC could not provide any information to quantify this fee and its effect on the overall pricing structure. Without further documentation, there is no assurance that ISAC is accounting properly for administrative costs when establishing tuition contract prices.

The primary control over Program costs is the passage of an annual budget by the Commission. However, even though Commission members raised questions when approving the budget, there was never a change to the proposed budget in the six years examined. Other large increases, such as a 363 percent increase in intra-agency services in fiscal year 2010, went unquestioned when approved by the Commission. Commission members were not provided information on actual expenses that they could use to compare to the approved budgeted amounts.

ISAC does not have a set policy for how Program costs are allocated. Although ISAC follows the same basic method each year, there is no policy or methodology in place to ensure that costs are allocated consistently from year to year. This resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts. This method also makes the process appear arbitrary and makes it difficult to determine the true cost of operating the program.

INTRODUCTION

House Resolution Number 174 directed us to examine the growth in recent years of program costs. To meet this determination, we examined program costs from fiscal year 2006 through fiscal year 2011.

FEES CHARGED TO CONTRACT PURCHASERS

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program. An administrative load fee was included as part of tuition contract prices. However, ISAC could not provide any information to quantify this fee and its effect on the overall pricing structure. Without further documentation, there is no assurance that ISAC is accounting properly for administrative costs when establishing tuition contract prices. The difference between the fees collected and the operation costs comes from participant contributions and investment income.

Fee Schedule

The Illinois Prepaid Tuition Act (Act) states that charges and expenses shall be paid exclusively from the Illinois Prepaid Tuition Trust Fund (Fund). The Fund was created as the repository of all moneys received by the Commission in conjunction with the Illinois prepaid tuition program. The Fund is a non-appropriated fund; therefore, all Program funding is derived entirely from payments received from contract purchasers and the investment income earned by the Fund.

The Act goes on to state that administrative costs shall be provided from reasonable fees and charges equitably assessed to purchasers of prepaid tuition contracts. The fee schedules are established for each enrollment period and are included in each year's enrollment kit. The fee schedule from the 2010-2011 enrollment period is shown in Exhibit 4-1. Program fees are separated into three main categories: administrative fees, service fees, and cancellation fees. Administrative fees are used to cover general administrative costs of the Program. Service fees pay the cost of providing a particular service. Cancellation fees are assessed only when an account is cancelled.

To see how fees have evolved over time, we examined the fee schedules established by the Commission since the first enrollment period in 1998-1999. Overall, fees remained very similar throughout the thirteen enrollment periods with the exception of the elimination of application fees (administrative category) in the 2008-2009 enrollment period and the way administrative fees were charged beginning in the 2009-2010 enrollment period.

Prior to the 2008-2009 enrollment period, an application fee ($85 in 2007-2008) was charged for new contract applications. In addition, prior to the 2009-2010 enrollment period, an account maintenance fee of $3 per payment was charged. Both of these administrative fees were cancelled. Beginning with the 2009-2010 enrollment period, the only fee listed under administrative fees was administrative load. The description of this fee was to ensure adequacy of annual program administration. However, there was no set amount for this fee. The fee schedule stated that this amount was included in contract prices.

Exhibit 4-1
COLLEGE ILLINOIS FEE SCHEDULE
2010-2011 Enrollment Period

Type of Fee	Description	Amount
ADMINISTRATIVE FEES		
Administrative load	Ensure adequacy of annual program administration	Included in contract prices
SERVICE FEES		
Late payment – monthly payment plan	Payment received after payment grace period	$20
Late payment – lump sum, annual or down payment	Payment received after payment grace period	1% of outstanding balance
Non-sufficient funds/returned payment	Payments returned by financial institution	$20
Change payment schedule	Change in payment schedule	$15
Change of Purchaser	Change of Purchaser of plan	$15
Change of Beneficiary	Change of Beneficiary of plan	$15
Change type of plan	Changing from one plan type to another	$15
Document replacement	New coupon book, welcome package, etc.	$15
Benefits transfer to private or out-of-state school	Processing private or out-of-state school invoice	$15 per institution attended
CANCELLATION FEES		
Cancellation – voluntary	Purchaser elects to cancel account	The lesser of $100 or 50% of amount paid
Cancellation – involuntary	Plan is canceled due to delinquency, incorrect information, etc.	The lesser of $100 or 50% of amount paid
Cancellation – fraud	Plan is canceled due to deliberate misrepresentation	The lesser of $500 or 100% of amount paid
Account maintenance – lump sum payment	Charge assessed for cancellation of lump sum plans	35 cents per month

Source: College Illinois fee schedule.

Including Administrative Costs in Tuition Contract Prices

Tuition contract prices are established prior to each year's enrollment period. Contract prices are developed in consultation with the Program's actuary and presented to the Commission for approval. The Commission is provided a summary of how the contract prices were developed and the factors considered.

We examined the summary for the most recent enrollment period which ran from November 1, 2010, through September 30, 2011, to determine how administrative costs were handled. This summary of contract prices, which was provided to the Commission for consideration at the Commission's meeting, noted the following:

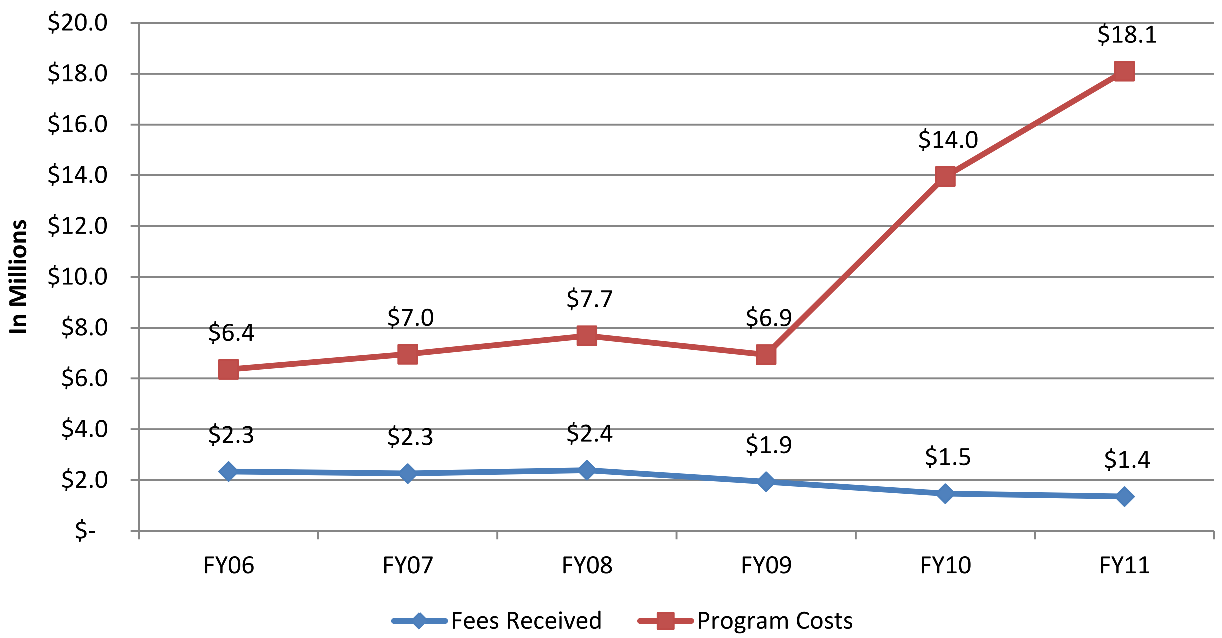
The program's administrative costs approved for FY2011 and each year thereafter are incorporated into contract pricing, including annual investment fees which reduce investment performance by less than half of one percent (i.e., 40 basis points), which reflects an expectation that in future years the current level of investment fees will trend higher due to investments in alternative assets.

The summary provided no further information to quantify the effect of administrative costs on the overall pricing structure. We requested further documentation on how contract prices were determined. However, ISAC was unable to provide any further documentation other than what appeared in the actuarial report and the Commission meeting minutes.

Fees Received from Contract Purchasers

The annual financial statements include the amount of the fees received by ISAC to cover College Illinois' administrative costs. Exhibit 4-2 shows the fees received for fiscal years 2006 through 2011. The exhibit also compares the fees received to the program costs. As can be seen in the exhibit, fees received have decreased while program costs have increased. In fiscal year 2006, the fees covered 37 percent of the total cost of operating the program. **By fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program.** Program costs will be covered in greater detail later in the Chapter.

Exhibit 4-2
FEES RECEIVED COMPARED TO PROGRAM COSTS



Source: OAG analysis of program costs and fees received.

PROCESS FOR ESTABLISHING FEES TO COVER ADMINISTRATIVE COSTS	
RECOMMENDATION NUMBER 13	***The Illinois Student Assistance Commission should assess its process for determining fees and charges assessed to purchasers of prepaid tuition contracts including maintaining documentation that quantifies the effect of administrative costs on the overall pricing structure.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. ISAC is reviewing its process for determining fees and charges to ensure that they are adequate and equitable. In addition, ISAC will clearly document how fees and charges affect the overall contract pricing structure.

BUDGET PROCESS

The primary control over Program costs is the passage of an annual budget. Each year, ISAC staff prepares a budget request which is presented to the Commission. The budget request compares the amount approved the previous year to the amount requested for the next year. The budget request also contains a narrative discussing the amounts requested and explaining increases and decreases compared to the previous year's budget. At the Commission meeting, the budget is presented and discussed. The Commission then votes to approve the budget.

We examined the budget requests for each year beginning with fiscal year 2006 through fiscal year 2011. We also examined the Commission meeting minutes for the discussion of the annual budget. While Commission members raised questions about the budget, there was never a change to the proposed budget in the six years examined.

Actual expenses were often lower than what was budgeted but also were frequently higher than what was budgeted. For example, in fiscal year 2009, the Commission approved $432,000 for intra-agency services. Intra-agency services represent other ISAC personnel and agency resources used to support the program. The actual expense totaled $999,165. Documentation indicated that the Executive Director and the Chief Program Officer approved an increase in the budgeted amount to $1,000,000. This was not brought to the Commission for approval.

The administrative portion of the budget increased significantly over the six year period doubling from $3.8 million to over $7.6 million. The biggest increases occurred in the areas of personal services and intra-agency services. Personal services increased by 298 percent while intra-agency services increased by 525 percent. Personal services consist of salaries and fringe benefits for the Program's full-time positions. Intra-agency services will be discussed in more detail in the next section.

It should be noted that the Commission did not approve a budget for College Illinois for fiscal year 2012. The budget was usually approved at the Commission's June meeting. However, the June meeting was rescheduled to July and the membership of the Commission was revamped during this time. The budget was never placed on the agenda and was not discussed.

While considering the fiscal year 2006 budget request, one Commissioner asked that a column of actual expenses be provided for future budget requests. ISAC officials stated that Commission members are provided budget vs. actual information as part of a package of financial information sent prior to each meeting. However, for the documents we examined, the budget categories did not agree with the budget that was approved by the Commission. Furthermore, budgeted vs. actual information is not incorporated into the budgetary documents examined by the Commission when approving the College Illinois budget each year.

BUDGET VS. ACTUAL EXPENSES	
RECOMMENDATION NUMBER 14	***The Illinois Student Assistance Commission staff should provide information to Commission members on budgeted vs. actual expenses. The information provided should coincide with the categories in the approved budget so that Commission members can make meaningful comparisons.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. ISAC will examine its presentation of financial information to the Commission Board to ensure the information is offered in a clear and consistent manner, and submit budgeted values to actual expenses on a quarterly basis.

COST ALLOCATION POLICY

ISAC does not have a set policy for how costs are allocated. Although ISAC follows the same basic method each year, there is no policy or methodology in place to ensure that costs are allocated consistently from year to year. This resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts.

Methods Used

While some costs can be directly attributed to the College Illinois Program, other costs are allocated to the Program. The costs of centralized functions such as legal and accounting are allocated to various programs, including College Illinois, based on management estimates.

When asked for the cost allocation policy, ISAC instead provided summaries of how the process had worked in the past. The three summary pages were titled as follows:

- Process to create internal budget and cost allocation – FY06 to FY09
- Process to create internal budget and cost allocation – FY 2010
- Process to create internal budget and cost allocation – FY 2011

The cost allocation was determined during the budget process which occurs during the third and fourth quarters of the preceding fiscal year. According to the summaries provided, the cost allocation process was as follows:

- Fiscal years 2006 to 2009 – ISAC developed an estimated cost allocation percentage by division based on discussions with directors for the various programs and functions.

- Fiscal year 2010 – ISAC prepared a shared cost allocation by employee by department based on input from managers and directors.

- Fiscal year 2011 – ISAC prepared a cost allocation survey by employee by department which was then submitted to the directors for approval. Once received back from the directors, the cost allocation percentages and personnel data were consolidated to determine the cost by programs and functions.

The majority of these allocated costs appear in the approved budget under intra-agency services. The budget for intra-agency services increased significantly from $432,000 in fiscal year 2009 to $2 million in fiscal year 2010. According to the meeting minutes, **this 363 percent increase went unquestioned when approved by the Commission.** The budget for intra-agency services increased again to $2.5 million in fiscal year 2011.

ISAC explained that the shared intra-agency costs were increased to more accurately reflect increased services allocated to the program to support salaries of agency personnel assisting with accounting, legal services, marketing, communications, procurement services, and other administrative tasks.

Actual Practice

Our examination showed that the method for allocating costs worked as described for the beginning of the process. In fiscal year 2010, ISAC developed a shared cost allocation by employee. For example, it was estimated that four employees from the Legal Department would spend between 20 – 30 percent of their time on College Illinois for an estimated total of $145,000. In total, the estimate for the shared cost allocation involved 82 employees contributing time to College Illinois for a total of $1.54 million. This amount was part of intra-agency services in the budget. The remainder of the $2 million budgeted for intra-agency services was estimated from other expenses such as telecommunications and rental of real property.

The actual allocation of expenses, however, worked much differently. Rather than allocate a percentage of the salary from each employee identified that worked on College Illinois, ISAC charged the entire salaries of selected individuals. For example, the salaries and benefits for two employees from the Legal Department were charged to College Illinois totaling $273,000. As mentioned in the previous paragraph, this had been estimated to be $145,000 for four employees. Overall, salaries and benefits from 30 employees totaling $1.94 million were charged to the College Illinois Program which was $0.4 million higher than estimated. An additional $59,000 in other expenses was also charged to bring the total close to the budgeted total of $2 million for intra-agency services.

ISAC officials stated that for efficiency and convenience purposes a majority of the shared expenses are charged to the personnel and payroll. Rather than move employees in and out of the fund for payroll, they pay a certain predetermined number of employees from the College Illinois Fund for the whole year. Officials also stated that if personal services expense does not cover the budgeted amount, invoices from other services are charged to cover the balance.

This method results in an inconsistent allocation of expenses from year to year. It also makes the process appear arbitrary and makes it difficult to determine the true cost of operating the program. These inconsistencies will be discussed in more detail in the next section.

COST ALLOCATION POLICY	
RECOMMENDATION NUMBER 15	***The Illinois Student Assistance Commission should establish a cost allocation policy or a payment methodology that establishes a reasonable basis of allocating expenses to ensure a consistent allocation of expenses from year to year.***
ISAC'S RESPONSE	**The Illinois Student Assistance Commission accepts this Recommendation**. ISAC is reviewing its cost allocation policies and procedures to help ensure that they are consistent, transparent, and readily understandable.

PROGRAM COSTS

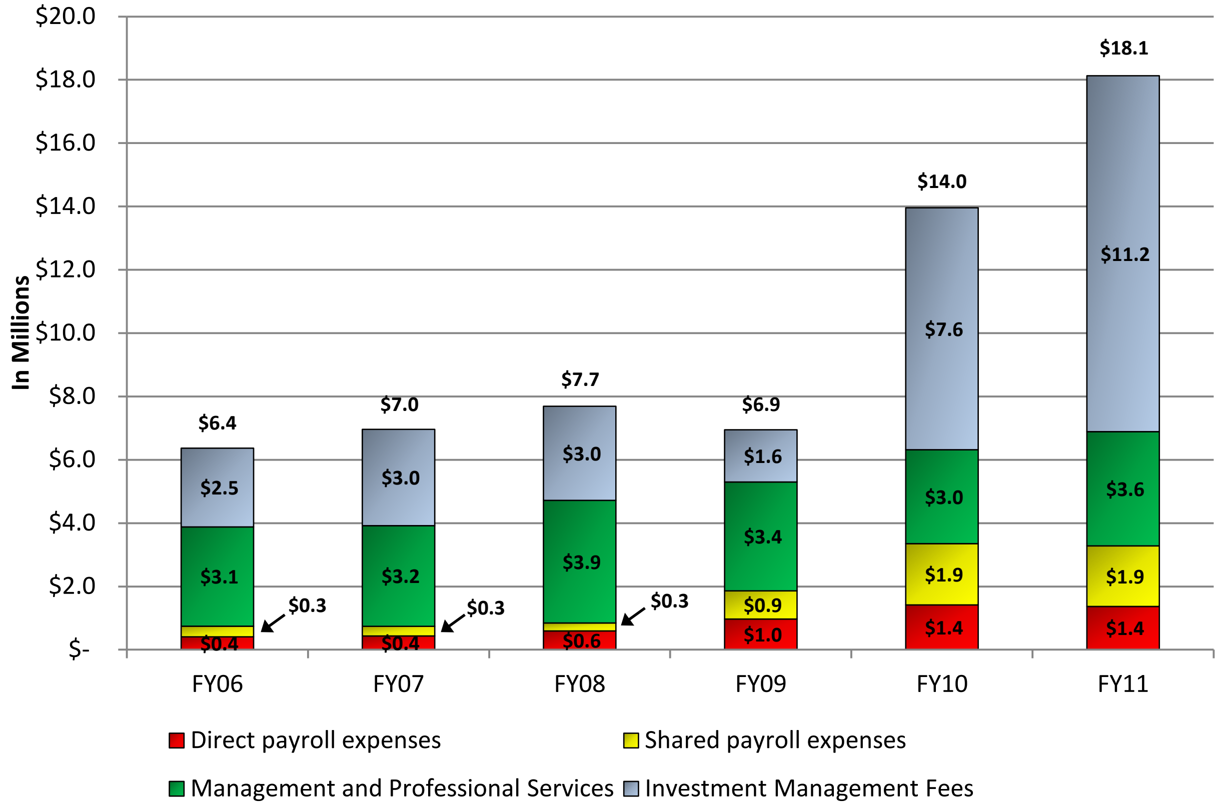
The cost of operating the College Illinois Program has risen dramatically over the last six years. Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011. The more funds spent on program costs, the less in funds to be invested with the Program, funds which will ultimately be used to pay tuition for contract holders.

As shown in Exhibit 4-3, costs have increased in each of the four categories:

- Direct payroll expense;
- Shared payroll expense;
- Management and professional services; and
- Investment management fees.

The most dramatic increase was in the category of investment management fees. Each category is described in more detail below.

Exhibit 4-3
PROGRAM COSTS
Fiscal Years 2006 – 2011



Source: OAG analysis of College Illinois program costs.

Direct Payroll Expense

Direct payroll expense more than tripled over the six year period increasing from $0.4 million in fiscal year 2006 to $1.36 million in fiscal year 2011.

Certain employees dedicate their entire time to the College Illinois Program. For these employees, salaries are charged directly to the Program. The primary reason direct payroll expense increased was that the number of employees working directly on the Program increased significantly over the six year period.

As shown in Exhibit 4-4, in fiscal year 2006, salaries for four employees were charged directly to the Program for a total payroll expense of just over $404,000. Comparatively, in fiscal year 2011, salaries and benefits for 19 different employees were charged to the Program for a total payroll expense of $1.36 million. Since some employees were not charged to College Illinois for the entire year, we calculated the full time equivalent (FTE) employees. This was calculated based on the number of pay periods an employee's salary was charged to the Program. For example, an employee whose salary was charged to the Program for three months during the year would represent .25 FTE. The FTE for each year is also shown in Exhibit 4-4.

Exhibit 4-4
COLLEGE ILLINOIS DIRECT EMPLOYEES

Fiscal Year	Number of Direct Employees	FTE[1]	Direct Payroll Expense
2006	4	4.0	$ 404,174
2007	4	4.0	431,825
2008	6	5.3	590,244
2009	12	8.0	966,141
2010	17	12.0	1,411,721
2011	19	11.5	1,363,093

[1]FTE is full time equivalent employees and was calculated based on the number of pay periods an employee's salary was charged to the Program.

Source: OAG analysis of direct payroll data.

Personnel Testing

We questioned $613,000 in salaries and benefits for eight different employees charged as a direct payroll expense to the College Illinois Program because there was insufficient documentation to show how much, if any, of their duties pertained to the Program. To determine if charges for direct payroll were appropriate, we tested 24 employees whose salaries were charged as direct payroll expense. Personnel files were examined to determine the nature of the positions held by the employees and whether those positions related directly to the College Illinois Program.

For 8 of the 24 employees examined (33%), position descriptions and other information in the file indicated that the positions did not relate directly to the College Illinois Program. Salaries and benefits charged as a direct payroll expense for these eight employees totaled $613,000. Salaries and benefits for these employees should not have been charged as direct payroll expense. If the positions included partial time spent on the College Illinois Program, those employees should be included in the shared payroll expense. We were unable to determine what percent of the $613,000 should have been included as shared payroll expense. Below is a case example.

Case Example One – Web Content Manager
In July 2009, ISAC hired a person in the position of Web Content Manager. The position description states: *The website Content Manager will be responsible for developing the voice for all aspects of the organization's online presence.* One of the primary job duties listed was to coordinate web projects across all divisions and departments. The College Illinois Program was not mentioned specifically anywhere in the position description. While the position may have some duties related to College Illinois, it clearly did not relate directly to the Program. The salary and benefits for this position, totaling $195,000, were charged to the College Illinois Program as a direct payroll expense from the time the person was hired in July 2009 through March 2011. At that time, the position was removed from the list of employees being charged to direct payroll expense. As of December 2011, the person continued to work at ISAC in the same position.

ISAC officials stated that the positions were properly charged to College Illinois. However, documentation provided was not sufficient to show that the duties performed by the individuals related exclusively to College Illinois.

Shared Payroll Expense

Shared payroll expense increased significantly over the six year period from $0.3 million in fiscal year 2006 to $1.9 million in fiscal year 2011. As opposed to employees that work directly on the College Illinois Program, many employees provide services to the Program as part of their overall job duties. As discussed under the Cost Allocation Policy section earlier, during the budget process, ISAC determines the percentage of time that employees spend on the College Illinois Program. The total for all of these employees is included in the budget under inter-agency services.

The reason shared payroll expense increased is simply that ISAC began charging the College Illinois Program more for the employees that contributed time to the program. ISAC explained that the shared intra-agency costs were increased to more accurately reflect increased services allocated to the Program to support salaries of agency personnel assisting with accounting, legal services, marketing, communications, procurement services, and other administrative tasks.

Management and Professional Services

Charges for management and professional services were mostly steady over the six year period increasing from $3.1 million in fiscal year 2006 to $3.3 million in fiscal year 2011. However, many expenses were allocated inconsistently from year to year.

Charges for management and professional services contain many of the budgetary categories presented to Commission members as part of the budget process. Expenses in this category include:

- Marketing;
- Contractual (records administration services, actuarial services, etc.);
- Telecommunications;
- Postage & Freight;
- Printing;
- Commodities;
- Equipment; and
- Travel.

Expenses in this category also include charges that were budgeted under intra-agency services. These would include all non-personnel charges. Exhibit 4-5 shows charges for management and professional services for fiscal years 2006 – 2011. The descriptions are those used by ISAC. Many of the charges are consistent from year to year. For example:

- Actuarial services – ISAC contracts with an actuary to perform a required annual actuarial assessment. A gradually increasing charge can be seen in each year.
- Marketing – As required by the Illinois Prepaid Tuition Act, ISAC contracts with a marketing agent to market the College Illinois Program. The charge in fiscal year 2010 was lower because ISAC brought many of the functions in-house.
- Record keeping – ISAC contracts with a firm to provide account services for tuition contract holders. The firm also provides call center services. The increase in this charge is attributable to the volume of contracts serviced.

A closer examination, however, reveals several inconsistencies. Some inconsistencies are easily explained. For example, a data communications charge of $4,800 was incurred each year except fiscal year 2011. This was a payment for maintenance of ISAC's website and was brought in-house in fiscal year 2011. Other inconsistencies are not as easily explained. For example:

- Electricity – An electricity expense was incurred in fiscal years 2006 and 2008 but none for the other four years.
- Information technology – Information technology expenses were incurred in 5 of 6 years but none in fiscal year 2009. Also the charge in 2 of the years was substantially less.
- Postage – A postage expense was incurred in 5 of 6 years but none in fiscal year 2011.

Exhibit 4-5
CHARGES FOR MANAGEMENT AND PROFESSIONAL SERVICES

Description	FY06	FY07	FY08	FY09	FY10	FY11
Actuarial services	$50,000	$50,000	$53,500	$75,000	$86,000	$96,463
Advertising				5,000	423,316	205,796
Advisory services						284,375
Audit expense	51,021	81,092	66,060	85,219	69,741	54,901
Auto maintenance				3,528		
Background checks					4,250	
Catering			80			868
Commodities					1,564	5,548
Computer software				3,900	6,624	4,575
Conference and dues	2,539	3,585	500	3,867	2,500	7,640
Contractual services					97	
Data communications	4,800	4,800	4,800	4,800	4,800	
Due diligence report services				1,339		
Electricity	17,821		19,694			
Electronic data processing equipment	1,330	935	4,997			1,999
Employee expense reimbursement	100	125	124	110	1,740	1,599
Employee tuition reimbursement				546	4,620	4,620
Equipment	159				1,236	239
Equity research services				1,000		
Financial advisory services				255,600		
Financial services				30,000		
Information technology	10,000	90,000	2,798		81,091	91,476
Insurance					69,440	21,951
Investment advisor	83,500	87,500	124,000	130,000	140,000	140,000
Investment consultant				2,475		
Investment custodian	132,859	119,002	149,297	138,411	146,703	243,304
Legal services				41,821	305,349	108,766
Market research					9,999	
Marketing outreach				10,000		
Marketing services	1,811,200	1,700,000	2,157,316	1,479,020	331,221	1,223,574
Office supplies	1,034	817	1,460	2,078	601	850
Office support	346	380	383	412		
Outsourced internal audit expense				2,718		
Payment processing	24,164	26,640	30,103	32,236	32,987	31,489
Postage	5,184	6,497	6,417	7,894	9,600	
Printing		42	406	422	10,828	1,954
Promotional expense						2,750
Record keeping	925,262	999,222	1,071,482	1,041,019	1,165,005	1,132,647
Refund of prior year expenses	(5,468)	(3,138)	(126)	(7,764)	(12,323)	(67,982)
Rent				25,882		
Research services						1,000
Reverse deposit in error					205	
Shared building expense	10,000		156,869	16,400		
Shared expense					9,040	
Subscription		46	71		293	115
Telephone	561	413	5,562	33,486	5,514	
Travel	8,676	11,095	16,083	11,128	16,910	6,822
Unpaid sick and vacation expense					36,478	
Total	**$3,135,089**	**$3,179,053**	**$3,871,875**	**$3,437,547**	**$2,965,427**	**$3,607,339**

Note: Totals may not add due to rounding.

Source: OAG analysis of College Illinois expenses.

- Shared building expense – An expense was incurred under the description shared building expense in 3 of 6 years but none in the other 3 years. One of charges was substantially higher than the other two.

- Telephone – There was a significantly larger charge for telephone expense in fiscal year 2009 and none in fiscal year 2011.

ISAC officials explained that ISAC does not have an internal service fund which could charge other funds for shared services. In lieu of this, they allocate invoices to be paid from the College Illinois Fund. At the end of the fiscal year, if personal services expense does not cover the budgeted amount, other invoices are charged to cover the balance. This results in variances in charged expenses between fiscal years.

As discussed in the next section, investment management fees paid to managers of alternative investments have been substantially higher. Alternative investments also have added costs in the area of management and professional services:

- In fiscal year 2009, ISAC paid a firm $255,600 for due diligence services (shown under financial advisory services in Exhibit 4-5) related to a direct private equity investment in ShoreBank. For other investments, due diligence services were typically conducted by an investment consultant who was under contract with ISAC. Due diligence was one of the many functions performed by the College Illinois investment consultant. In fiscal year 2009, the investment consultant was paid $130,000 for the various functions performed compared to the $255,600 paid for one due diligence.

- In fiscal year 2011, ISAC paid a firm $271,875 for due diligence services (shown under advisory services in Exhibit 4-5) for two real estate investment managers. As noted above, these services were typically performed by the College Illinois investment consultant. In fiscal year 2011, the investment consultant was paid $140,000 for the various functions performed compared to the $271,875 paid for these due diligence services.

- College Illinois incurred charges of $305,349 in fiscal year 2010 and $108,766 in fiscal year 2011 for legal services. This compared to $41,821 in fiscal year 2009 and none for any of the three years prior to that. Much of the legal services expense related to alternative investments.

Investment Management Fees

Investment management fees have increased significantly from $2.5 million in fiscal year 2006 to $11.2 million in fiscal year 2011. The reason for the large increase is that fees paid to managers of alternative investments have been substantially higher. Funds were invested in alternative investments beginning in fiscal year 2010.

As discussed in Chapter Two, ISAC contracts with various investment managers to manage College Illinois funds. Investment managers are selected for various categories of investments and ISAC pays fees to the investment managers for managing the funds. The fees are outlined in agreements with each of the investment managers.

Fees are generally paid as percent of the amount invested. So as the value of the College Illinois Fund increases, the amount paid for investment fees would increase. Exhibit 4-6 shows the market value of the fund at the end of each fiscal year and the amount of fees paid for that fiscal year. In fiscal year 2006, management fees paid represented 0.31 percent of the total fund value. This percent was consistent for the next two years before dropping to 0.18 percent in fiscal year 2009. ISAC stated that this was due to its new Chief Investment Officer negotiating lower fees with the investment managers.

Exhibit 4-6
INVESTMENT MANAGEMENT FEES AS A PERCENT OF TOTAL ASSETS
(in millions)

	FY06	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**
Fees paid	$2.5	$3.0	$3.0	$1.6	$7.6	$11.2
Market value of assets	$791.1	$996.5	$996.2	$893.0	$985.5	$1,121.1
Fees as a percent of assets	0.31%	0.31%	0.30%	0.18%	0.78%	1.00%

Source: OAG analysis of fees paid.

However, in fiscal year 2010, the percent of fees to total assets increased significantly to 0.78 percent. This coincided with College Illinois investing in alternative investment categories of real estate, private equity, hedge funds, and infrastructure. In fiscal year 2011, the percentage increased even more to 1.00 percent of the total fund value.

In fiscal years 2010 and 2011, investment managers in the alternative investment categories were paid $16.6 million of the $18.8 million in management fees paid. One firm, which is an infrastructure investment manager, has been paid $3.97 million in fees since being first funded in December 2009 through June 30, 2011. As of June 30, 2011, the market value of the fund managed by the infrastructure investment manager was $19.4 million. The market value of the individual funds as of June 30, 2011, is shown in Appendix C.

Chapter Five

ASSET ALLOCATION

CHAPTER CONCLUSIONS

The College Illinois asset allocation has evolved over the last six years. In 2006, the Fund was invested entirely in traditional asset classes: fixed income, equity, and cash. Conversely, in 2011, these asset classes accounted for 58 percent of the Fund while the remaining 42 percent was invested in alternative investments: private equity, hedge funds, real estate, and infrastructure.

We contracted with a consultant, Ibbotson Associates, to perform an independent asset allocation study of the College Illinois current investment mix as directed by House Resolution 174. **The analysis was of the asset allocation as of June 30, 2011, and was not an analysis of the actual past performance of the portfolio.** Results of the analysis included the following:

- Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments. Returns were lower for the shorter time periods examined but higher for the longer time periods. A forward looking analysis showed that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

- **It is important to note that the allocation study used benchmark indices for the different asset classes. The actual investments made by College Illinois and their performance may differ.** To perform the analysis, Ibbotson analyzed College Illinois' asset allocation as of June 30, 2011, and selected benchmarks to accommodate the study. Ibbotson noted that decisions made when implementing an asset allocation policy with different investment managers have the potential to significantly add or detract value by introducing manager specific risk. As an example, College Illinois recently invested $14 million in a single company. This investment involved a high degree of risk in that the company is in a relatively early stage of development with little operating history. In addition, Chapter Two notes several issues with ISAC's selection of investment managers including selecting two managers outside of the normal procurement process.

- The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined. The state with the least risky portfolio concentrated the majority of its assets in fixed income investments. Only 1 of the other 4 states examined included alternative investments in its portfolio. This state's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois.

- The College Illinois program differentiates itself from the programs of other states by having a more diversified asset allocation policy. Both the target and actual asset allocations offer exposures to a larger number of asset classes than the portfolios of the other states. Historically, alternative asset classes such as private equity, hedge funds and infrastructure had lower correlations to the traditional asset classes. Therefore, adding these asset classes to a traditional equity and fixed income portfolio has the potential to improve a portfolio's risk and return characteristics.

- Although the overall asset allocation is well diversified as measured by the number of asset classes in the opportunity set, there is a lack of diversification within the traditional fixed income portion of the portfolio.

- In addition, while the exposure to alternative asset classes was one of the strengths of the College Illinois asset allocation, the individual weights to the alternative asset class do not seem to be optimal given the results for mean-variance optimization and they seem to be concentrated in the hedge fund asset class.

While the asset allocation study showed that a portfolio with alternative investments was less risky compared to a standardized portfolio without alternative investments, there are other issues to consider when using alternative investments. The lengths of the agreements with investment managers for alternative investments are much longer making the portfolio less liquid. Management fees were also substantially higher and additional outside costs were incurred related to legal services and due diligence services.

INTRODUCTION

House Resolution Number 174 directed us to conduct an independent asset allocation study of College Illinois Program investments to determine the overall level of risk associated with the Program's current alternative investment mix. The Resolution directed that this study shall be conducted in comparison with a standardized investment portfolio containing no alternative investments, as well as a comparison with actual investment portfolios of similar public prepaid tuition programs currently operating in the states of Michigan, Virginia, Washington, and Florida.

In August 2011, the Office of the Auditor General issued a Request for Proposals for a consultant to conduct the asset allocation study required in the audit resolution. Three firms submitted proposals. The firm selected was Ibbotson Associates. Ibbotson was founded in 1977 and was acquired by Morningstar, Inc. in 2006. Ibbotson is a registered investment advisor and wholly owned subsidiary of Morningstar. Ibbotson is a leading independent asset allocation provider offering investment advisory services and customized research.

TARGET ASSET ALLOCATION

The Program's Statement of Investment Policy establishes the target asset allocation for the Program's funds. The Investment Policy is one of the Program's primary control mechanisms. The Executive Director is responsible for preparing the policy and the Commission approves any changes.

The most recent revision to the Investment Policy was approved by the Commission on January 22, 2010. Exhibit 5-1 shows the target asset allocation and permissible percentage ranges from the Investment Policy. The exhibit also shows the actual asset allocation as of June 30, 2011, for the asset classes used in the Investment Policy. All of the asset classes shown fall within the allowable ranges.

Exhibit 5-1
TARGET ASSET ALLOCATION AND PERMISSIBLE PERCENTAGE RANGES
Investment Policy Approved January 22, 2010

Asset Class	Target	Minimum	Maximum	Actual as of 6-30-11
Fixed Income:				
Broad Fixed Income	15.0%	10.0%	20.0%	13.1%
Intermediate Government/ Credit	5.0%	3.0%	8.0%	5.7%
U.S. Treasury Inflation Protected Securities	5.0%	2.0%	10.0%	3.0%
Mortgage/Other	5.0%	0.0%	10.0%	0.0%
Total Fixed Income	30.0%			21.8%
Equity:				
Total Domestic Equity	15.0%	10.0%	25.0%	24.1%
Total International Equity	8.0%	5.0%	12.0%	9.9%
Total Equity	23.0%			34.0%
Real Estate: [1]				
Real Estate	10.0%	5.0%	15.0%	
Real Estate (GSA)[2]	10.0%	0.0%	15.0%	
Total Real Estate	20.0%			15.1%
Alternative Investments:				
Private Equity	7.0%	0.0%	12.0%	11.1%
Hedge Funds	15.0%	5.0%	20.0%	14.3%
Infrastructure	5.0%	0.0%	10.0%	1.7%
Total Alternatives	27.0%			27.1%
Total Cash	0%	0.0%	5.0%	1.9%

[1]The College Illinois Investment Policy does not include Real Estate under the category “Alternative Investments.” Analysis throughout this report does consider Real Estate as an alternative investment.

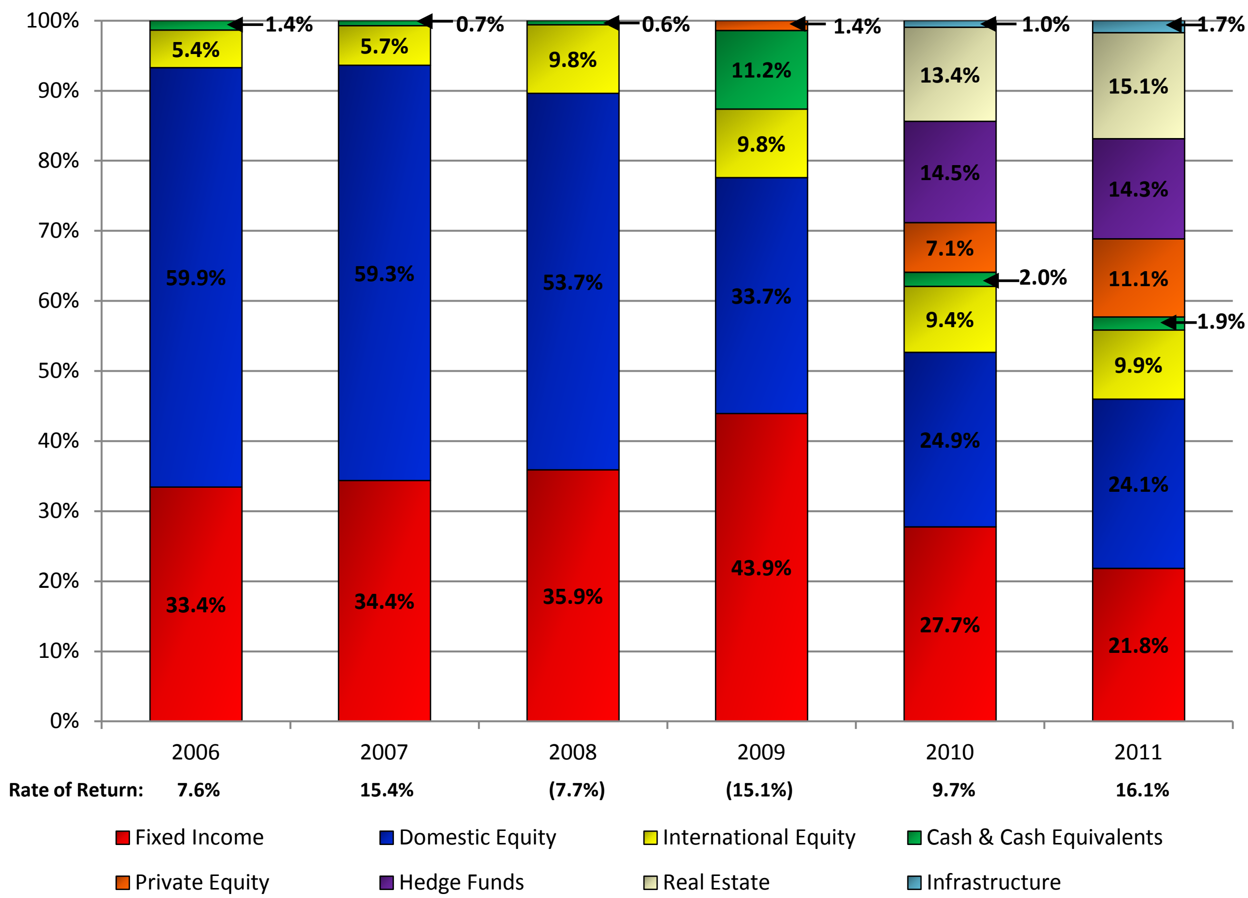
[2]Real Estate (GSA) is not defined anywhere in the Investment Policy but appears to refer to the U.S. General Services Administration which provides workspace for federal workers.

Source: College Illinois Statement of Investment Policy and investment reports.

ACTUAL ASSET ALLOCATION

Exhibit 5-2 shows how the Fund's asset allocation has evolved over the last six years. In 2006, the Fund was invested entirely in traditional asset classes: fixed income, equity, and cash. Conversely, in 2011, these asset classes accounted for 58 percent of the Fund while the remaining 42 percent was invested in alternative investments: private equity, hedge funds, real estate, and infrastructure.

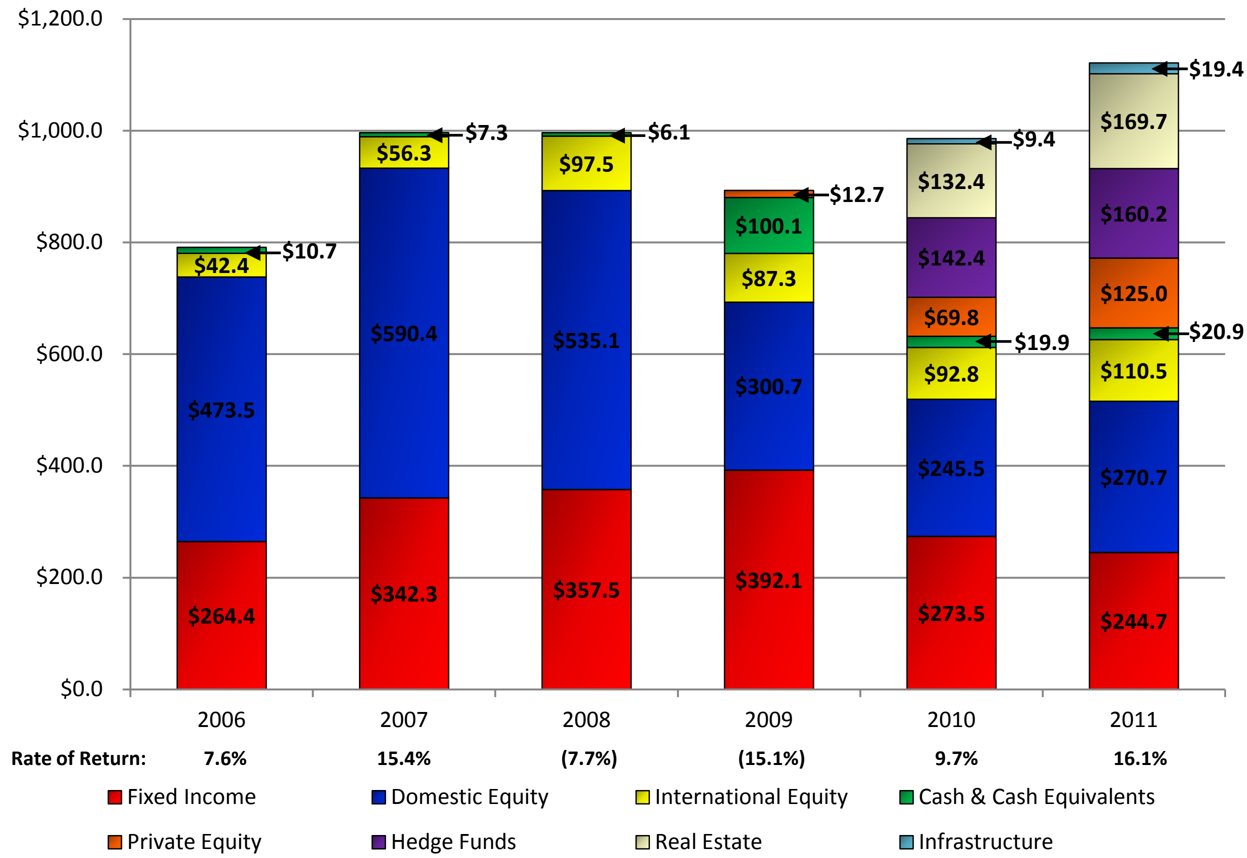
Exhibit 5-2
COLLEGE ILLINOIS ASSET ALLOCATION – PERCENTAGE ALLOCATION
FY06 – FY11



Source: OAG analysis of College Illinois investment data.

Exhibit 5-3 shows the same asset allocation information except in dollars. In 2006, assets totaled $791.1 million. This grew to $996.5 million in 2007 before falling to $996.2 million in 2008 and $893.0 million in 2009. The total assets rebounded to $985.5 million in 2010 and $1,121.1 million in 2011.

Exhibit 5-3
COLLEGE ILLINOIS ASSET ALLOCATION – DOLLAR ALLOCATION
FY06 – FY11 (In Millions)



Source: OAG analysis of College Illinois investment data.

COMPARISON TO A STANDARDIZED PORTFOLIO

Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments. Returns were lower for the shorter time periods examined but higher for the longer time periods. A forward looking analysis showed that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

It is important to note that College Illinois' actual investments were not used in the analysis. Instead, the analysis used benchmark indices for the different asset classes. The actual investments made by College Illinois and their performance may differ.

To perform the analysis, Ibbotson analyzed College Illinois' asset allocation as of June 30, 2011, and selected benchmarks to accommodate the study. Ibbotson noted that decisions made when implementing an asset allocation policy with different investment managers have the potential to significantly add or detract value by introducing manager specific risk. As an example, College Illinois recently invested $14 million in a single company. This investment involved a high degree of risk in that the company is in a relatively early stage of development with little operating history. In addition, Chapter Two notes several issues with ISAC's selection of investment managers including selecting two managers outside of the normal procurement process.

To establish a standardized portfolio without alternative investments, Ibbotson rolled up the alternative asset classes into the traditional asset classes. This was done by determining the exposure of each alternative asset class to the traditional asset classes using return-based style analysis. The corresponding percentages were then allocated to the traditional asset classes. The standardized portfolio consisted solely of the following asset classes: fixed income, domestic equity, international equity, TIPS, and cash. TIPS refers to United States Treasury Inflation Protected Securities which are part of College Illinois' current portfolio under fixed income.

Once a standardized portfolio was established, Ibbotson analyzed the historical performance over various time periods. **This analysis assumed a static weighting of the College Illinois asset allocation over the time period referenced.** In other words, the weights of the asset allocation as of June 30, 2011, remained constant for the various time periods examined. Exhibit 5-4 shows the risk and return of College Illinois' actual asset allocation as of June 30, 2011, compared to a standardized portfolio without alternatives for various time periods.

Compared to a standardized portfolio, the College Illinois portfolio with alternative investments was less risky for all of the time periods examined. The measure of risk used is the standard deviation which measures the investment's volatility. The higher the standard deviation is, the more volatile the investment would be.

For return, the results were mixed. For the 3 year and 5 year time periods, the return of the College Illinois portfolio with alternative investments was less than the standardized portfolio. However, for the 10 year and 20 year time periods, the return for the College Illinois portfolio was higher.

Exhibit 5-4
COMPARISON TO A STANDARDIZED PORTFOLIO WITHOUT ALTERNATIVE INVESTMENTS

	College Illinois Portfolio	Standardized Portfolio
Return:		
3 yr (7/08 – 6/11)	3.47%	4.42%
5 yr (7/06 – 6/11)	5.09%	5.31%
10 yr (7/01 – 6/11)	6.78%	6.07%
20 yr (7/91 – 6/11)	9.23%	8.09%
Forward looking analysis	7.87%	7.62%
Risk:		
3 yr (7/08 – 6/11)	12.75%	17.47%
5 yr (7/06 – 6/11)	10.61%	13.97%
10 yr (7/01 – 6/11)	9.42%	12.42%
20 yr (7/91 – 6/11)	8.43%	10.84%
Forward looking analysis	10.22%	12.37%

Note: The measure of risk used is the standard deviation which measures the investment's volatility. The higher the percentage, the higher the risk.

Source: Ibbotson asset allocation study.

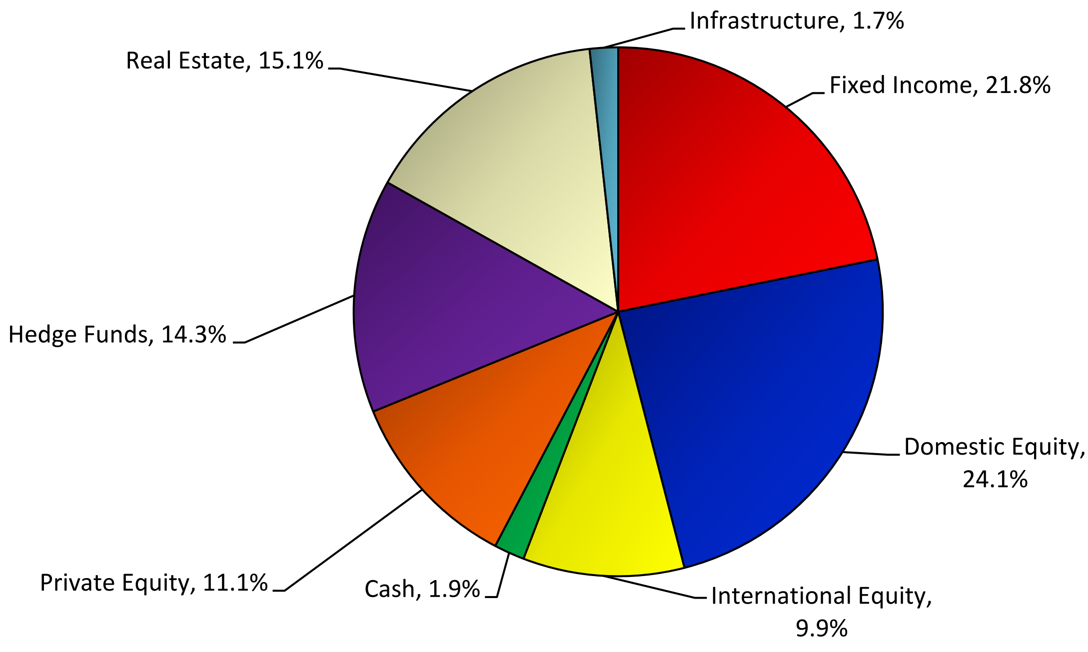
Ibbotson also created forward looking capital market assumptions and projected future expected returns and standard deviation calculations for both the College Illinois portfolio and the standardized portfolio. As shown in Exhibit 5-4, the forecasted results show that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

COMPARISON TO OTHER STATES' PORTFOLIOS

Due to its diversification in a wider variety of asset classes, the College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined. The state with the least risky portfolio concentrated the majority of its assets in fixed income investments. Only 1 of the other 4 states examined included alternative investments in its portfolio. This state's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois.

House Resolution 174 asked us to compare the College Illinois asset allocation to the actual investment portfolios of similar prepaid tuition programs. The Resolution specified the states of Florida, Michigan, Virginia, and Washington. The following sections contain pie charts that show the asset allocations of the different states. The charts show the different asset classes and the percentage invested in each. States use different terminology for their asset classes and those names are what are used in the pie charts. For comparison purposes, the College Illinois asset allocation as of June 30, 2011, is shown in Exhibit 5-5.

Exhibit 5-5
COLLEGE ILLINOIS ASSET ALLOCATION
As of June 30, 2011

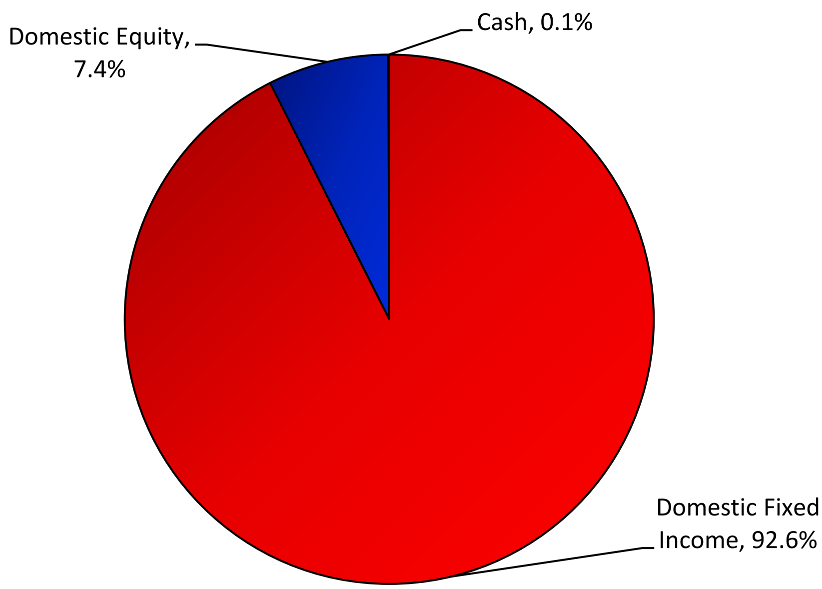


Source: College Illinois investment reports.

Florida

The Florida Prepaid College Plan was started in 1987. As of June 30, 2011, Florida's fund totaled $8.5 billion which was by far the largest of the states examined. The most recent actuarial report showed that Florida was 105.1 percent funded as of June 30, 2010. Florida's asset allocation as of June 30, 2011, is shown in Exhibit 5-6.

Exhibit 5-6
FLORIDA PREPAID COLLEGE PLAN ASSET ALLOCATION
As of June 30, 2011



Source: Florida Prepaid College Plan.

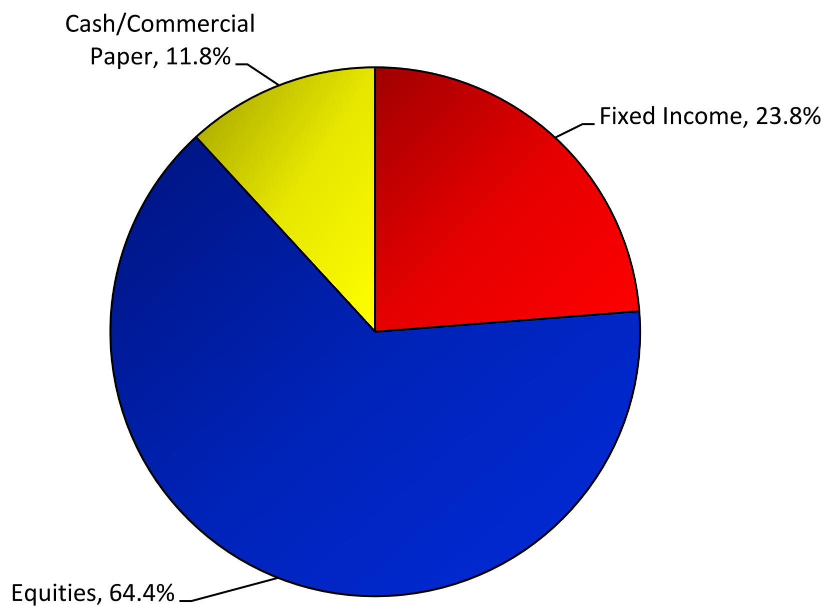
As shown in Exhibit 5-6, Florida's portfolio consists almost entirely of fixed income investments with a small percentage invested in domestic equity. The following highlights the differences between the Florida and College Illinois portfolios:

- Florida allocated 92.6 percent of its portfolio to fixed income compared to only 21.8 percent for College Illinois.
- Florida allocated 7.4 percent to domestic equity compared to 24.1 percent for College Illinois. Florida did not allocate any funds to international equity.
- Florida's portfolio does not contain any alternative investments compared to 42 percent invested in alternative investments for College Illinois.

Michigan

The Michigan Education Trust was first started in 1988. The first three enrollments (1988, 1989, and 1990) were known as plans B and C. The current active plan is known as Plan D. The asset allocation for Plan D is shown in Exhibit 5-7. As of August 31, 2011, the Michigan Plan D fund totaled $599 million. The most recent actuarial report available showed that Plan D was 83.3 percent funded as of September 30, 2010.

Exhibit 5-7
MICHIGAN EDUCATION TRUST ASSET ALLOCATION
As of August 31, 2011



Source: Michigan Education Trust.

Like Florida, Michigan's portfolio does not contain any alternative investments. It is limited to fixed income, equities, and cash. The following highlights some of the differences between the Michigan and College Illinois portfolios:

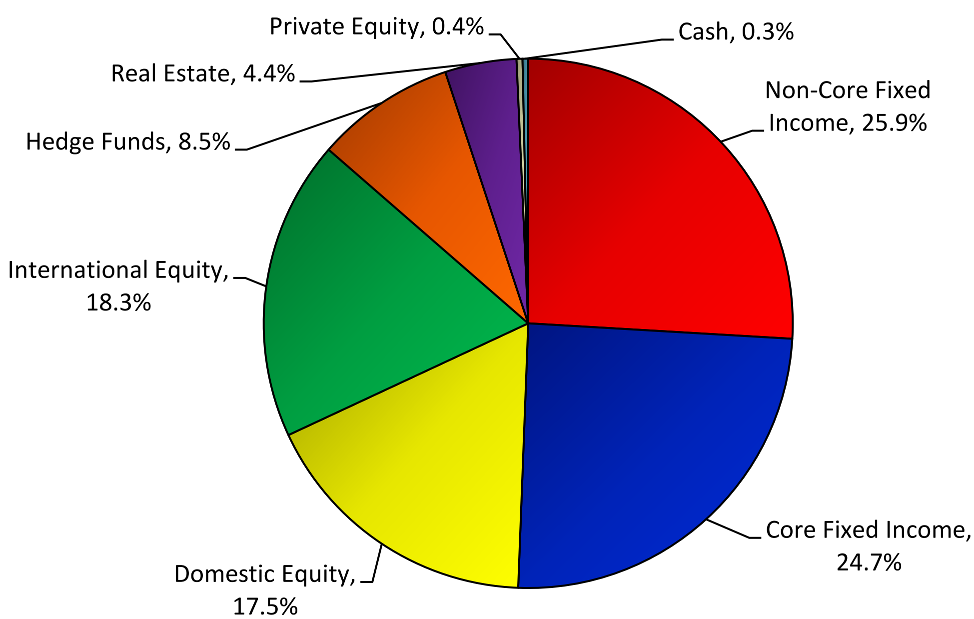
- The biggest difference is that College Illinois allocated 42 percent of its fund to alternative investments while Michigan had no alternative investments.
- Michigan has a much higher percentage (64.4%) allocated to equities compared to College Illinois (34.0%). Ibbotson separated Michigan's equity category into domestic equity (46.9%) and international equity (17.5%). In contrast, College Illinois allocated 24.1 percent to domestic equity and 9.9 percent to international equity.
- Michigan allocated more to cash compared to College Illinois (11.8% to 1.9%).

- The amount allocated to fixed income was similar with 23.8 percent for Michigan and 21.8 percent for College Illinois.

Virginia

The Virginia Prepaid Education Program was started in 1996. As of June 30, 2011, Virginia's fund totaled $1.9 billion and was 100.5 percent funded on an actuarial basis. Virginia's asset allocation as of June 30, 2011, is shown in Exhibit 5-8.

Exhibit 5-8
VIRGINIA PREPAID EDUCATION PROGRAM ASSET ALLOCATION
As of June 30, 2011



Source: Virginia Prepaid Education Program.

Of the four states examined, Virginia was the only state to include alternative investments in its portfolio. These alternative investments include hedge funds, real estate, and private equity. Virginia's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois. The following highlights some of the differences between the portfolios:

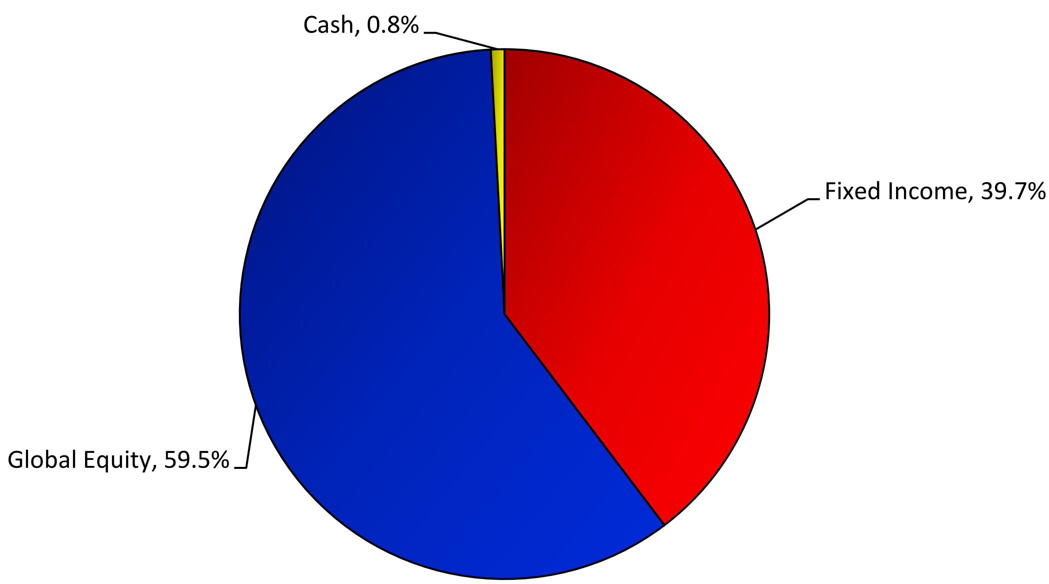
- Virginia has 50.6 percent invested in fixed income compared to 21.8 percent for College Illinois. Virginia breaks down fixed income into core fixed income and non-core fixed income. The non-core fixed income portion is comprised of convertible bonds, high yield, and emerging markets fixed income. Ibbotson noted that there is no direct exposure to these three asset classes within the College Illinois portfolio. Based on Ibbotson data, these three asset classes have a lower correlation with traditional asset classes and may potentially offer diversification benefits when combined with traditional asset classes.

- For alternative investments: Virginia has 8.5 percent in hedge funds compared to 14.3 percent for College Illinois; 4.4 percent in real estate compared to 15.1 percent for College Illinois; 0.4 percent in private equity compared to 11.1 percent for College Illinois; and no allocation for infrastructure compared to 1.7 percent for College Illinois.

Washington

The Washington Guaranteed Education Tuition Program was started in 1998. As of June 30, 2011, Washington's fund totaled $1.9 billion and was 80.3 percent funded on an actuarial basis. Washington's asset allocation as of June 30, 2011, is shown in Exhibit 5-9.

Exhibit 5-9
WASHINGTON GUARANTEED EDUCATION TUITION PROGRAM ASSET ALLOCATION
As of June 30, 2011



Source: Washington Guaranteed Education Tuition Program.

Like Florida and Michigan, Washington's portfolio does not contain any alternative investments. It is limited to fixed income, global equity, and cash. The fixed income portion consists mainly of TIPS which accounts for 29.1 percent of the entire portfolio. The following highlights some of the differences between the Washington and College Illinois portfolios:

- The biggest difference is that College Illinois allocated 42 percent of its fund to alternative investments while Washington had no alternative investments.

- Washington has a much higher percentage (59.5%) allocated to equities compared to College Illinois (34.0%). Because of a lack of detail, we were unable to differentiate between domestic and international equity.

- Washington also allocated a higher percentage to fixed income (39.7%) compared to College Illinois (21.8%). Within fixed income, Washington allocated 29.1 percent to TIPS compared to only 3 percent for College Illinois.

Comparing College Illinois to the Four States

The College Illinois asset allocation as of June 30, 2011, was the second less risky of the states examined. Ibbotson analyzed the historical performance of the College Illinois and other states' portfolios over various time periods. This analysis assumed a static weighting of the asset allocations over the time period referenced. In other words, the weights of the asset allocation remained constant for the various time periods examined. Exhibit 5-10 shows the risk and return of College Illinois' portfolio compared to the other states' portfolios for various time periods.

Exhibit 5-10
COMPARISON OF COLLEGE ILLINOIS TO OTHER STATES

	College Illinois	Florida	Michigan	Virginia	Washington
Return:					
3 year (7/08 – 6/11)	3.5%	6.5%	4.4%	5.7%	4.7%
5 year (7/06 – 6/11)	5.1%	6.4%	4.7%	6.4%	5.5%
10 year (7/01 – 6/11)	6.8%	5.7%	5.3%	7.6%	6.3%
Forward looking analysis	7.9%	4.6%	7.5%	7.7%	7.3%
Risk:					
3 year (7/08 – 6/11)	12.7%	3.7%	17.7%	15.9%	17.3%
5 year (7/06 – 6/11)	10.6%	3.4%	14.2%	12.6%	13.7%
10 year (7/01 – 6/11)	9.4%	3.3%	12.9%	11.1%	12.1%
Forward looking analysis	10.2%	6.9%	13.1%	10.9%	13.0%

Note: This analysis assumed a static weighting of the asset allocations over the time period referenced and does not represent the actual returns of the portfolios over those time periods.

Source: Ibbotson asset allocation study.

For example, looking at the three year analysis, Florida's portfolio had by far the lowest risk of the states examined. This would be expected given Florida's high concentration in fixed income investments. The measure of risk used is the standard deviation which measures the investment's volatility. The higher the standard deviation is, the more volatile the investment would be. The College Illinois portfolio had the next lowest risk at 12.7 percent. This ranking, with College Illinois being the second less risky portfolio, was true for all of the time periods examined.

Looking at return for the three year analysis, the College Illinois portfolio had the lowest return of the states examined. Return increased for the College Illinois portfolio as the length of the time period increased. In the forward looking analysis, the College Illinois portfolio was expected to have the highest return.

Efficient Frontier Analysis

Ibbotson also charted the College Illinois portfolio on the efficient frontier. (See Exhibit 5-11.) An efficient frontier is the line that connects all optimal portfolios across all levels of risk. An optimal portfolio is simply the mix of assets that maximizes portfolio return at a given risk level. The optimal portfolios plotted along the curve have the highest expected return possible for the given amount of risk. A portfolio above the curve is not possible.

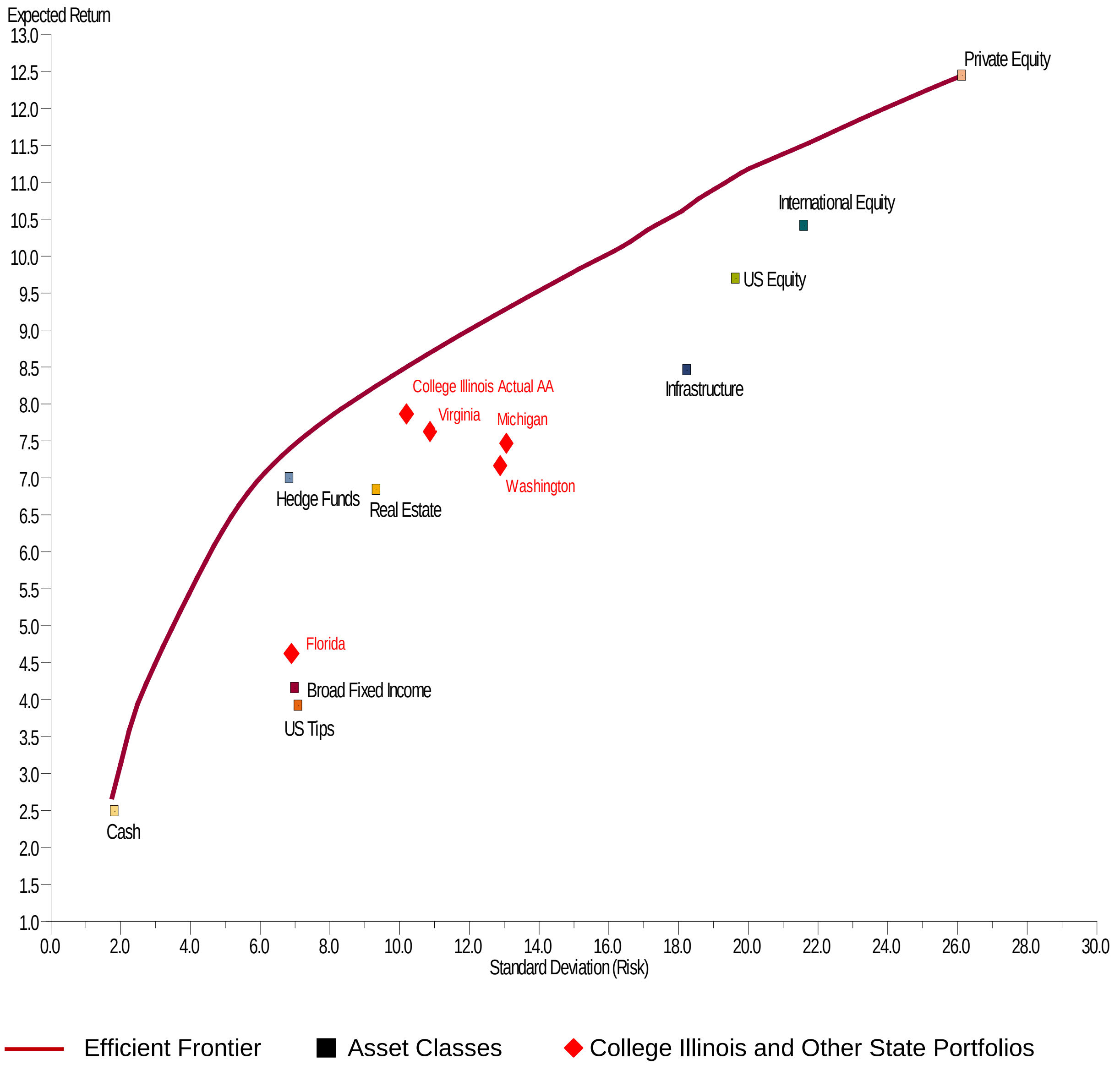
The efficient frontier line highlighted in dark red represents the College Illinois frontier. Also depicted are the individual asset classes and existing allocations for College Illinois. The numbers used in the analysis are forward looking. The exhibit also shows where the other states portfolios would appear on the College Illinois efficient frontier. Each state would have its own efficient frontier line based on its asset mix.

The following highlight the key points from the exhibit:

- The closer the portfolio is to the curve the more efficient the portfolio.
- On a forward looking basis, the College Illinois portfolio has the potential to have the highest return with only one state being less risky.
- For the level of return of the College Illinois portfolio, there is an optimal portfolio that would provide the same return with less risk. Similarly, for the level of risk of the College Illinois portfolio, there is an optimal portfolio that would provide a greater return.

Exhibit 5-11

COLLEGE ILLINOIS EFFICIENT FRONTIER



Source: Ibbotson analysis of the College Illinois and other states asset allocations.

STRENGTHS AND WEAKNESSES

As part of the asset allocation study, Ibbotson was asked to outline strengths and weaknesses of the College Illinois asset allocation based on the analysis performed.

Strengths

1. The College Illinois program differentiates itself from the programs of other states by having a more diversified asset allocation policy. Both the target and actual asset allocations offer exposures to a larger number of asset classes than the portfolios of the other states. For example, out of the four other states that Ibbotson analyzed, only the portfolio for the Virginia prepaid tuition program has exposures to alternative asset classes. Overall, College Illinois allocates to nine distinct asset classes.

   Ibbotson in principle advocates building asset allocation portfolios with a diversified set of asset classes as the risk-adjusted return of portfolio may be improved by including additional not perfectly correlated asset classes. Over long periods of time, a more robust asset allocation mix has the potential for achieving a relatively better risk-adjusted performance.

2. Based on Ibbotson's historical analysis, the College Illinois asset mix had a lower risk and relatively similar return for all periods we studied. While the lower risk is a strength of the College Illinois asset mix, the recent historical return results are somewhat skewed from the long-term expectations due to the recent global financial crisis. The period between 2007 and 2009 was marked by increased correlations among all asset classes which reduced the benefits of a well diversified portfolio. However, over long periods of time that include more market cycles, asset mixes that include a larger number of asset classes tend to outperform on a risk-adjusted basis.

3. The College Illinois portfolio exposure to the alternative asset classes increased the risk-adjusted returns of the portfolio as evidenced by the mean-variance optimization using Ibbotson's expected returns, standard deviations and correlations. Historically, alternative asset classes such as private equity, hedge funds and infrastructure had lower correlations to the traditional asset classes. Therefore, adding these asset classes to a traditional equity and fixed income portfolio has the potential to improve a portfolio's risk and return characteristics.

Weaknesses

1. Although the overall asset allocation is well diversified as measured by the number of asset classes in the opportunity set, there is a lack of diversification within the traditional fixed income portion of the portfolio. In general, Ibbotson advocates diversification along duration factors, credit quality and geography when optimizing the fixed income portion of a portfolio. This diversification may be achieved at the implementation level, but spelling it out in the asset allocation policy may be beneficial.

2. Related to #1 above, the allocation to Treasury Inflation Protected Securities (TIPS) seems low when comparing the actual weights to the weights for the college tuition programs of

other states. For example, the Virginia plan allocates 11 percent to TIPS and Washington allocates 29 percent. Because the liability of a college prepaid plan, that is the value of future college tuition payments, is impacted by future inflation, TIPS may offer a "hedge" against future inflation. Viewing College Illinois' asset allocation from this liability-driven perspective supports the view that an increased portfolio weighting to TIPS may lead to a more optimal portfolio outcome.

3. The exposure to alternative asset classes was mentioned above as one of the strengths of the College Illinois asset allocation. However, the individual weights to the alternative asset class do not seem to be optimal given the results for mean-variance optimization and they seem to be concentrated in the hedge fund asset class. Ibbotson recognizes that hedge funds encompass a broad mix of different investments and trading strategies and, due to the complexities of this asset class, Ibbotson performs additional optimization within this asset class when building asset allocation portfolios.

TRADITIONAL INVESTMENTS VS. ALTERNATIVE INVESTMENTS

The asset allocation study showed that a portfolio with alternative investments was less risky compared to a standardized portfolio without alternative investments. However, there are other issues to consider when using alternative investments. These issues, some of which have been discussed in other sections of the report, include:

- Length of the agreements – The lengths of the management agreements with alternative investment managers are substantially longer compared to traditional investments. For example, the agreements for the traditional asset classes of fixed income, domestic equity, and international equity were one year in length with three options to extend by an additional year. Conversely, the agreement for infrastructure, as an example, was 10 years. The move to longer agreements makes the portfolio less liquid.

- Investment management fees – Fees paid to investment managers for alternative investments have been substantially higher compared to traditional investments. Fees paid are discussed in more detail in Chapter Four.

- Other added costs – The Program has incurred additional costs related to alternative investments for due diligence services and external legal services. These costs are discussed in Chapter Four.

In addition, many of the issues discussed in Chapter Two regarding the procurement process related to procurements involving investment managers for alternative investments.

Chapter Six

MARKETING OF THE PROGRAM

CHAPTER CONCLUSIONS

Assessing the intent of marketing materials is a difficult endeavor. There is not a set standard to measure against and the intent is thus open to different interpretations. However, **the marketing materials examined made statements that could lead a purchaser to believe that an investment in College Illinois was backed by the State, was safe and secure, and transferred the risk to the State**.

The Illinois Student Assistance Commission (ISAC) made changes to the marketing materials over the years. In 2008, ISAC removed the term "backed by the State" from its marketing materials including press releases, enrollment booklets, and the Annual Report. However, ISAC continued to promote that an investment in College Illinois was safe and secure, was not tied to the stock market, and transferred risk from the purchaser to the State.

At the same time, ISAC added language to its Master Agreement (a document included in a Program contract which describes the basic terms and conditions of the Program) to emphasize the risk involved.

MARKETING OF THE PROGRAM

During our review of marketing materials and Program enrollment information, we examined College Illinois contract materials (master agreements and participation and pricing information) from the Program's thirteen enrollment periods (1998-1999 through 2010-2011) as well as marketing materials including but not limited to annual reports, blogs, marketing highlights, fact sheets, newsletters, and press releases to determine how the Program was portrayed.

Marketing Materials

We reviewed more than 200 marketing materials from all enrollment periods. These marketing materials included but were not limited to direct mail, fact sheets, press releases, public service announcements, and blogs. Marketing materials were examined to see how the Program was portrayed and how it changed over time.

Backed by the State

Marketing materials did not use the term backed by the "full faith and credit" of the State of Illinois. Marketing materials did, however, use language such as backed by the State or secured by the State. For example:

- From a February 9, 2000 press release: "*College Illinois!* provides the state-backed assurance that tuition and fees, no matter how much they might increase by the time a student begins college, will be covered..."

- From a December 3, 2001 press release: "This unique college funding option, which is the only 529 plan backed by the State of Illinois..."

- Several press releases during the period 2002 – 2006 contained the following statement: "*College Illinois!* is secured by the state of Illinois."

In 2008, marketing materials stopped using the terms "backed by the State" and "secured by the State." This change could also be seen in the College Illinois Annual Report. Prior to 2008, the Annual Report contained the following language:

> *As the only college funding tool backed by the state of Illinois, College Illinois! can protect purchasers against tuition and fee increases that historically have averaged 8.0 percent per year during the past twenty years at public universities in Illinois.*

The fiscal year 2008 Annual Report removed the opening phrase that the Program was backed by the State of Illinois and contained only the following:

> *College Illinois! can protect purchasers against tuition and fee increases that historically have averaged 8.0 percent per year during the past twenty years at public universities in Illinois.*

At the November 2009 Commission meeting, it was noted that for the 2008-2009 enrollment period:

> *"... [ISAC] stopped using the phrase 'backed by the state,' started talking more about State's 'moral obligation' to the program."*

Safe and Secure

Marketing materials also promoted the concept that an investment in College Illinois was safe and secure, was not tied to the stock market, and transferred risk from the purchaser to the State. For example:

- From a 2000 brochure: "Unlike 529 college savings plans, College Illinois! is a sure thing. As a 529 prepaid tuition plan, we're not affected by soaring tuition costs, stock market volatility or a loss in your purchasing power."

- From a press release dated March 14, 2003: "*College Illinois!* is a secure college funding option because benefits do not fluctuate with the stock market. Similar to an insurance policy, *College Illinois!* is a contract between the purchaser and the state of Illinois that ensures tuition and fee benefits for college."

- From a press release dated October 6, 2009: "...the College Illinois! 529 Prepaid Tuition program is solid. College Illinois! assets are both safe and liquid...our actuarial assumptions are very, very conservative."

- From a press release dated November 25, 2009: "A College Illinois! 529 Prepaid Tuition Program contract between the purchaser and the State of Illinois ensures tuition and fee benefits for college, regardless of fluctuations in the market."

- From a blog dated March 17, 2010: "...I'm offering these tips to getting the pot of gold at the end of the college savings rainbow: ...Mitigate risk and seek security with a legally-binding contract while meeting tuition needs. A College Illinois! 529 Prepaid Tuition Program contract allows the purchaser to lock in a price for future tuition and fees while saving for college, thus transferring the risk to the State of Illinois."

Program Enrollment Materials

Master Agreement

The Master Agreement is one of three documents included in a Program contract. Program Master Agreements contain ten articles which describe the basic terms and conditions of the Program. As noted in *Article I - Introduction,* a contract between the purchaser and ISAC consists of the application, Master Agreement and Disclosure Statement, and the Participation and Payment Schedule. The remaining nine articles outline Program definitions; participation; benefits; payments; use of benefits; termination, cancellation, expiration, and refund; transfer and substitution; fees; and general provisions/disclosures/risk factors. Each of the Articles contains numbered subsections regarding specific areas.

Article X focuses on general provisions and disclosures and includes a subsection on the Fund. By definition, the Fund, also known as the Prepaid Tuition Trust Fund, is "the repository of all moneys received by the Commission including all contributions, appropriations, fees, interest and dividend payments, gifts, or other financial assets received in connection with operation of the Program." The disclosures found within this subsection focus on Program feasibility and the State's responsibility to the Program should the Commission determine there are insufficient funds to pay contractual obligations.

Several statements related to sufficient funds and Program feasibility have appeared in the subsection related to the Fund of Article X for all 13 enrollment periods. All agreements note that: funding is based on payments received from contract purchasers and investment income and benefits are limited to the assets and earnings of the Fund; and conservative actuarial assumptions are used to ensure fiscal obligations are satisfied.

The provisions and disclosures related to the Fund significantly changed in 2009-2010 and 2010-2011 as compared to prior enrollment periods. For the prior 11 enrollment periods, the language in the Master Agreement generally remained the same. The term "risk" was not used. In 2009-2010, disclosures emphasized risk associated with participation in the program. The title of the Article itself was changed from General Provisions/Disclosures to General Provisions/Disclosures/Risk Factors.

All agreements contained two statements regarding the Commission's responsibility and authority should there be insufficient funds to satisfy future obligations and the Program is determined to be financially infeasible. Both of these requirements mirror what is in the Illinois Prepaid Tuition Act. For the 2008-2009 enrollment period, one of these statements appeared as follows:

> "If the Commission determines that there are insufficient moneys in the Fund to pay contractual obligations in the next succeeding fiscal year, the Commission shall certify the amount necessary to meet these obligations to the Board of Higher Education, the Governor of Illinois, the President of the Senate of Illinois, and the Speaker of the House of Representatives of Illinois. The Governor shall submit the amount so certified to the General Assembly as soon as practicable, but no later than the end of the current State fiscal year. Nevertheless, neither the credit nor the taxing power of the State of Illinois is pledged to the payment of Benefits under a Contract."

In the 2009-2010 Master Agreement, this statement was amended to emphasize the risk involved and appeared as follows:

> "If the Commission determines that there are insufficient moneys in the Fund to pay contractual obligations in the next succeeding fiscal year, the Commission shall certify the amount necessary to meet these obligations to the Board of Higher Education of the State of Illinois, the Governor of Illinois, the President of the Senate of Illinois, and the Speaker of the House of Representatives of Illinois. The Governor shall submit the amount so certified to the Illinois General Assembly as soon as practicable, but no later than the end of the current State fiscal year. **THE GENERAL ASSEMBLY IS NOT OBLIGATED TO APPROPRIATE, AND NO ASSURANCES CAN BE MADE THAT THE GENERAL ASSEMBLY WILL APPROPRIATE, SUFFICIENT MONEYS TO MEET THE PROGRAM'S CONTRACTUAL OBLIGATIONS. NEITHER THE CREDIT NOR THE TAXING POWER OF THE STATE OF ILLINOIS IS PLEDGED TO THE PAYMENT OF BENEFITS UNDER A CONTRACT.**"

In another example, Article X of the Master Agreement included a statement on the actuarial assumptions. In the 2009-2010 Master Agreement, the following was added to that statement in bold and capital letters:

> **ACTUARIAL ASSUMPTIONS INVOLVE ASSESSMENTS OF PROSPECTIVE EVENTS; NO ASSURANCES CAN BE GIVEN THAT SUCH ACTUARIAL ASSUMPTIONS SHALL PROVE TO BE ACCURATE.**

Enrollment Booklet

In addition to the Master Agreement, auditors reviewed enrollment booklets which are provided to prospective enrollees and give general information to those interested in joining the Program. We analyzed each of the booklets to determine how the marketing message changed over time. Throughout most enrollment periods, certain phrases such as “safe and secure” and “offering a peace of mind” have been associated with the Program. Additionally, for the majority of the periods, the Program was marketed as offering protection against stock market volatility or a loss in purchasing power and/or protection against tuition and fee inflation. However, not all guarantees were consistently used across enrollment periods. The guarantees that were seen in beginning enrollment periods were replaced by phrases which distinguished the Program from other prepaid savings plans and emphasized no ties to the stock market and later reassured prospective enrollees by emphasizing the Program’s professional management and diversified portfolio.

The phrase “backed by the State” was referenced through the 2007-2008 enrollment period. However, this phrase was removed from the 2008-2009 enrollment booklet. In the 2009-2010 enrollment booklet, the following was added:

> “The College Illinois! 529 Prepaid Tuition Program is required to request a legislative appropriation of funds from the Illinois General Assembly in the event the fund which pays out benefits is in danger of not being able to meet its obligation to contract holders. Any such appropriation would then be made at the discretion of the General Assembly.”

Certain assurances appeared through the 2005-2006 enrollment period:

- From the 1998-1999 enrollment booklet - “No matter how much public tuition and fees increase, they will be covered;”

- From the 1999-2000 enrollment booklet - “College Illinois!...is rooted in certainty...can assure you from the moment of purchase how many semesters’ tuition and fee bills will be paid in full...You can’t achieve any more certainty than that;” and

- From the 2005-2006 enrollment booklet - “...you can rest assured that when your child is ready to attend college, his or her prepaid plan will be there for tuition expenses. College Illinois! is your secure choice.” And “College Illinois! truly is a secure and worry-free way to manage one of your most important financial goals.”

Beginning in 2006-2007, the College Illinois Program began being compared to other 529 savings plans and there was a focus on the Program not being tied to the stock market.

- From a comparison of security of plans in the 2006-2007 and 2007-2008 enrollment booklets - College Illinois is “backed by the State of Illinois” whereas, with other savings plans there is no guarantee. “Investments are subject to market conditions” and “Savings may not be sufficient to cover tuition and fees.”

- From the 2007-2008 and 2008-2009 enrollment booklet - “You’re not tied to the stock market as with 529 savings plans...There are no investment worries with the *College Illinois!* prepaid tuition plan” and “*College Illinois!*...more like insurance than an investment. The value is not tied to the stock market. Your benefits will not fluctuate - they’re fixed and secure, for the life of the contract.”

The enrollment booklet for the 2009-2010 enrollment period removed some of the previous statements and placed reliance on Program management and professionals.

- The comparison of plans was still used; however, the "no guarantee" as referenced with other savings plans in the previous enrollment booklets was removed.

- "Your contract benefits are not dependent on the stock market's performance because the College Illinois! 529 Prepaid Tuition Program's conservatively managed fund insulates your investment from the market's fluctuations."

- "There are no worries or hassles because the College Illinois! 529 Prepaid Tuition Program is not an investment that requires monitoring like many other investments such as 401k retirement plans or the 529 savings alternative."

- "The program investment portfolio is diversified into various asset groups including money markets, bonds, equities, private equities and alternative assets. The portfolio is managed by ISAC and a diverse group of investment managers and other professionals to ensure diversification and to control risks over the long term."

Annual Reports

The Program's Annual Reports contained a "Program Overview" that generally followed the same message that was portrayed in the enrollment kits. As noted earlier, beginning in fiscal year 2008, the phrase "backed by the State" was removed from the annual report.

- From the FY99 and FY00 Annual Reports - "*College Illinois!*...can immunize purchasers against tuition and fee inflation, stock market volatility and any decline in family purchasing power..."

- From the FY02 – FY10 Annual Reports - "*College Illinois!* provides individuals with an opportunity to lock in the cost of future tuition and mandatory fees, protecting against tuition inflation."

Commission Meetings

Documentation from Commission meetings suggests that the State's responsibility to the Program was unclear to Commission members. It was also noted that marketing materials stopped using the phrase "backed by the State."

September 2006

Commission members appeared unclear as to the State's responsibility to the Program. During the September 2006 Commission meeting, the Commission Chairman questioned what would happen if in some future year the program did not have sufficient funds to pay benefits. The Director of College Illinois explained that "contract purchasers can rely upon the force of contract law, statutory backing for the program, as well as the State's moral obligation to back the program."

January 2009

At the January 2009 Commission meeting, documentation provided to the Commissioners noted that "*College Illinois!* continues to press on the notion of affordability and security against the whims of the stock market..."

November 2009

At the November 2009 Commission meeting, documentation provided to Commissioners stated: "Also in 2008-2009, we stopped using the phrase 'backed by the State,' started talking more about State's 'moral obligation' to the program..." With regard to the 2009-2010 enrollment period, there was mention of downplaying "College Illinois!" as a brand and emphasizing the versatility of prepaid tuition programs in general.

State Backing: Full Faith and Credit vs. Moral Obligation

The College Illinois Program is not backed by the full faith and credit of the State of Illinois. Instead, it has been referred to as a moral obligation of the State.

In 1997, when the Illinois Prepaid Tuition Act was being considered by the General Assembly, the bill contained a full faith and credit guarantee. However, an amendment removed the full faith and credit guarantee and replaced it with moral obligation language. Governor Edgar filed an amendatory veto to make the moral obligation language consistent with other Acts that required a similar State commitment. The General Assembly agreed and the bill became Public Act 90-546 on December 1, 1997.

The former Director of College Illinois provided a letter to a State Senator dated March 18, 2001, where the issue of moral obligation was discussed. In the letter, the former Director noted that when the Program was being formulated, the question of State backing for the Program was discussed and backing the Program with a moral obligation of the State was agreed upon.

The letter contends that "full faith and credit" backing would be detrimental to the Program. According to the former Director, the then Bureau of the Budget staff insisted that "full faith and credit" backing would require that a limit be placed on the value of contracts offered for sale each year and make the Program subject to the general obligation bond authorization limit. This would annually constrict the Program's capacity and would jeopardize the certainty of the Program's annual enrollment period. The letter concludes that "ISAC does not perceive any need for legislation that would alter the strong state backing already provided for the program."

The statutory language found in the Illinois Prepaid Tuition Act matches similar language found in statutes for entities that can issue moral obligation bonds, but does not specifically reference the backing as a moral obligation of the State. The Illinois Prepaid Tuition Act which created the Program outlines a course of action should the Commission determine there are insufficient moneys in the Illinois Prepaid Tuition Trust Fund to pay contractual obligations.

The Illinois Prepaid Tuition Act states:

> *If the Commission determines that there are insufficient moneys in the Illinois Prepaid Tuition Trust Fund to pay contractual obligations in the next succeeding fiscal year, the Commission shall certify the amount necessary to meet these obligations to the Board of Higher Education, the Governor, the President of the Senate, and the Speaker of the House of Representatives. The Governor shall submit the amount so certified to the General Assembly as soon as practicable, but no later than the end of the current State fiscal year*. (110 ILCS 979/35(e))

According to the Illinois Constitution, the moral obligation pledge represents an obligation of the State but not the absolute requirements as defined by full faith and credit. Indebtedness which is secured by the full faith and credit of the State is required to be repaid. Other indebtedness including moral obligation bonds, such as those issued by the Program, are not secured by the full faith and credit nor required to be repaid.

APPENDICES

APPENDIX A

House Resolution Number 174

STATE OF ILLINOIS
HOUSE OF REPRESENTATIVES
97TH GENERAL ASSEMBLY

HOUSE RESOLUTION NO. 0174ENR

OFFERED BY REPRESENTATIVES JIM DURKIN-ELAINE NEKRITZ-CHAD HAYS-SANDRA M. PIHOS-LOU LANG, DANIEL V. BEISER, JACK MCGUIRE, KEITH FARNHAM, CAROL A. SENTE, DERRICK SMITH, ANN WILLIAMS, KAREN MAY, MARLOW H. COLVIN, DANIEL BISS, KELLY BURKE, MICHAEL P. MCAULIFFE, CHRIS NYBO, THOMAS MORRISON, SARA FEIGENHOLTZ, FRED CRESPO, SANDY COLE, KAY HATCHER, PATRICIA R. BELLOCK, DAN BRADY, DARLENE J. SENGER, JOANN D. OSMOND, MICHAEL J. ZALEWSKI, KEVIN A. MCCARTHY, WILLIAM CUNNINGHAM, JACK D. FRANKS, LINDA CHAPA LAVIA, DONALD L. MOFFITT, JOSEPH M. LYONS, PAM ROTH, JASON BARICKMAN, MICHAEL G. CONNELLY, DAVID R. LEITCH, JIM SACIA, DAVID HARRIS, JIL TRACY, NORINE HAMMOND, ADAM BROWN, WAYNE ROSENTHAL, DAVID REIS, RAYMOND POE, DWIGHT KAY, RICH BRAUER, JOHN D. CAVALETTO, RANDY RAMEY, JR. AND RICHARD MORTHLAND

WHEREAS, The College Illinois! prepaid tuition program has served Illinois families successfully for more than a decade, encouraging parents and grandparents to pay college tuition in advance through the purchase of State-sponsored prepaid tuition contracts; and

WHEREAS, The financial performance of the College Illinois! prepaid tuition program is critical to ensure the plan participants' ability to access funds when students are prepared to attend an institution of higher education; and

WHEREAS, The College Illinois! prepaid tuition program is not backed by the full faith and credit of the State of Illinois, but rather constitutes a moral obligation of the State, making the College Illinois! prepaid tuition program long-term investment portfolio vulnerable to risk-intensive investment practices; and

WHEREAS, In 2009, College Illinois! prepaid tuition program assets were virtually stocks and bonds in their entirety, but, by the conclusion of January 2011, the College Illinois! fund held $419 million or 38% in alternative investments such as hedge funds, real estate, and private equity investments; and

WHEREAS, Hedge funds and private equity investments often fail to provide an intensive level of transparency appropriate for public institutional investments of this kind; and

WHEREAS, The Illinois Student Assistance Commission's stated strategy is to pursue alternative investments until the College Illinois! prepaid tuition program portfolio reaches 47% in alternative investments such as hedge fund, real estate, and private equity investments; and

WHEREAS, In 2008, the Illinois Student Assistance Commission invested $12.7 million in ShoreBank, a privately held company and, in 2010, the entire $12.7 million was lost when federal regulators closed the bank; and

WHEREAS, As of June 30, 2007, the College Illinois! prepaid tuition program fund was 7% underfunded, and, as of June 2010, the date of the most recent figures available, the College Illinois!

prepaid tuition program fund was 31% underfunded; therefore, be it

RESOLVED, BY THE HOUSE OF REPRESENTATIVES OF THE NINETY-SEVENTH GENERAL ASSEMBLY OF THE STATE OF ILLINOIS, that the Auditor General shall conduct a management audit of the College Illinois! prepaid tuition program's administrative operations; and be it further

RESOLVED, That the audit include, but not be limited to, the following determinations:

(1) The growth in recent years of program costs; and
(2) The efficacy of the program's administration, and, in particular, the Illinois Student Assistance Commission's oversight and administrative capacity to evaluate and direct College Illinois! prepaid tuition program investments; and be it further

RESOLVED, That as a part of this audit, the Auditor General shall conduct an independent asset allocation study of College Illinois! prepaid tuition program investments to determine the overall level of risk associated with the program's current alternative investment mix; it is intended that this study shall be conducted in comparison with a standardized investment portfolio containing no alternative investments, as well as in comparison with actual investment portfolios of similar public prepaid tuition programs currently operating in the states of Michigan, Virginia, Washington, and Florida; and be it further

RESOLVED, That the Illinois Student Assistance Commission and any other entity having information relevant to this audit cooperate fully and promptly with the Auditor General's Office in the conduct of this audit; and be it further

RESOLVED, That the Auditor General commence this audit as soon as possible and report his findings and recommendations upon completion in accordance with the provisions of Section 3-14 of the Illinois State Auditing Act; and be it further

RESOLVED, That suitable copies of this resolution be delivered to the Auditor General and the Director of the Illinois Student Assistance Commission.

Adopted by the House of Representatives on April 14, 2011.

Mark Mahoney
MARK MAHONEY
CLERK OF THE HOUSE

Michael J. Madigan
MICHAEL J. MADIGAN
SPEAKER OF THE HOUSE

APPENDIX B

Audit Methodology

Appendix B
AUDIT METHODOLOGY

We conducted this performance audit in accordance with generally accepted government auditing standards and the audit standards promulgated by the Office of the Auditor General at 74 Ill. Adm. Code 420.310. 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.

The audit objectives for this audit were those as delineated in House Resolution Number 174 (see Appendix A), which directed the Auditor General to conduct a management audit of the College Illinois Prepaid Tuition Program's administrative operations. The audit objectives are listed in the Introduction section of Chapter One. Fieldwork for this audit was conducted from November 2011 to January 2012.

In conducting the audit, we reviewed applicable State statutes and rules. We reviewed compliance with those laws and rules to the extent necessary to meet the audit's objectives. Any instances of non-compliance we identified are noted in this report. We also reviewed management controls and assessed risk related to the audit's objectives. A risk assessment was conducted to identify areas that needed closer examination. Any significant weaknesses in those controls are included in this report.

During the audit, we met with officials from ISAC. We interviewed former and current officials at each of ISAC's three offices (Chicago, Deerfield, and Springfield). Officials interviewed included: the former executive director, former deputy executive director, former director of the College Illinois Program, current general counsel, associate general counsel, chief financial officer, two former chief investment officers, former director of portfolio management, human resources director, and chief marketing officer among various other officials having involvement with the College Illinois Program. We asked officials about their length of employment at ISAC, job duties related to the Program, and reporting authority. We again met with officials, as necessary, regarding the specific audit areas. We also met with the Attorney General's Office and the Secretary of State.

All thirteen Annual Reports for the College Illinois Program were obtained and reviewed. Historical comparisons across reports were made including a comparison of the funded ratio from year to year for the past 13 years. Additionally, the assumptions used to perform the actuarial valuation of the Fund were also compared across reports. We reviewed how the assumptions were developed for use in the actuarial analysis and who developed those assumptions. The appropriateness of the method used to calculate the fund deficit and any assumptions that were unsupported or unrealistic were examined.

To obtain on overview of program operations, we established an audit period of six years encompassing fiscal years 2006 through 2011. We determined the role of the Commission regarding the College Illinois program. Additionally, we reviewed over 40 Commission meeting minutes to determine who attended the meetings and what was discussed. Meeting minutes were also reviewed for investment decisions. We also examined 15 executive session minutes for relevant information on the selection of investment managers.

We analyzed changes in options and pricing for new tuition contracts. Over 200 marketing materials were examined to see how the Program was portrayed and how it changed over time. We obtained contract sales and cancellation data for the audit period. We reviewed the process for canceling tuition contracts including any fees involved and interest that is required to be paid.

We examined program costs and determined reasons for any increases and decreases in costs. We conducted personnel testing on 24 individuals whose salaries were charged directly to the College Illinois program. Inconsistencies in charges for management and professional services were also examined and explanations obtained. We compared budgets requests approved by the Commission each year to actual program costs.

ISAC conducted 14 procurements to obtain investment managers. We examined all 14 procurements to determine the process followed and how it changed over the time period. This examination included a review of the evaluation process. We also examined procedures for investing program funds. This examination included a review of the College Illinois Statement of Investment Policy (Policy). The Policy outlines fiduciary responsibility, internal controls and conflict of interest, and program investments including asset allocation, manager selection, and operational guidelines and objectives. Nine revisions to the Policy occurred during the audit period. Revisions were compared to determine how the policy has changed over time.

Additionally, we examined investment manager files specifically for managers receiving funding outside of the normal procurement process. Any due diligence conducted in association with the selection of investment managers was reviewed. Policies and procedures for investing program funds as well as the actual process for funding investment managers were examined. In addition to the Policy referenced above, other specific policies and procedures including ISAC's ethics policy and procedure for transferring funds between investment managers and College Illinois were reviewed.

We reviewed Investment Advisory Panel membership and meeting minutes to determine if statutory requirements were being met. We reviewed membership of the investment and portfolio committees. Additionally, committee meeting minutes were obtained and reviewed for compliance with the Policy. We met with ISAC's investment consultant, Marquette Associates, to determine their role in the investment process and how it has changed in recent years.

We contracted with a consultant to conduct an independent asset allocation study of College Illinois Program investments to determine the overall level of risk associated with the Program's current alternative investment mix. The asset allocation study also compared the College Illinois portfolio to a standardized investment portfolio containing no alternative investments, as well as the investment portfolios of similar public prepaid tuition programs currently operating in the states of Michigan, Virginia, Washington, and Florida.

In addition to the comparison of investment portfolios of four other states in the asset allocation study, we compared the College Illinois program to prepaid tuition programs in eleven states including a comparison of assets under management, open contracts, and program oversight.

APPENDIX C

Market Value of College Illinois Investments

as of June 30, 2011

Market Values June 30, 2011			
Asset Class	**Investment Manager**	**Market Values**	**Current Allocation**
Core Fixed Income	CS McKee Investment Managers	$71,270,484	6.4%
Core Fixed Income	Piedmont Investment Advisors	33,302,435	3.0%
Core Fixed Income	Pugh Capital Management	42,094,968	3.8%
Intermediate Fixed Income	Income Research & Management	64,298,464	5.7%
TIPS	TIPS Account	33,713,699	3.0%
Total Fixed Income		**244,680,050**	**21.8%**
All-Cap Core Equity	RhumbLine Advisers	193,072,861	17.2%
Large-Cap Core Equity	SSgA S&P 500 Index	77,616,200	6.9%
Total U.S. Equity		**270,689,061**	**24.1%**
International Large-Cap Equity	Ativo Capital	31,935,974	2.8%
International Large-Cap Equity	MacKay Shields	30,149,330	2.7%
International Large-Cap Equity	Harris – Pyford	32,296,819	2.9%
International Large-Cap Equity	SSgA MSCI EAFE Index	16,150,000	1.4%
Total International Equity		**110,532,123**	**9.9%**
Real Estate – Value Added	Kennedy Wilson Property III	20,470,357	1.8%
Real Estate – Value Added	Kennedy Wilson Property IV	18,695,214	1.7%
Real Estate – Opportunistic	Lyrical-Antheus Realty III	18,370,821	1.6%
Real Estate – Value Added	Mesirow Value	4,344,420	0.4%
Real Estate – Debt	Security Capital Stable Income	60,086,463	5.4%
Real Estate – Preferred	Security Capital Preferred Growth	47,713,616	4.3%
Total Real Estate		**169,680,891**	**15.1%**
Infrastructure	Alinda Capital II	19,403,437	1.7%
Total Infrastructure		**19,403,437**	**1.7%**
Hedge Fund of Funds	Balestra Spectrum II	55,230,709	4.9%
Hedge Fund of Funds	NB Diversified Arbitrage	27,167,572	2.4%
Hedge Fund of Funds	Pinnacle Natural Resources	56,101,825	5.0%
Hedge Fund – Market Neutral	Reynoso	21,677,813	1.9%
Total Hedge Funds		**160,177,919**	**14.3%**
Private Equity Fund of Funds Secondary	Camelot Secondary Fund	10,674,235	1.0%
Private Equity – Co-Invest	Camelot Co-Investment	18,732,381	1.7%
Private Equity Fund of Funds Secondary	Morgan Stanley Secondary Fund	10,921,734	1.0%
Private Equity Fund of Funds Secondary	Portfolio Advisors Secondary Fund	9,938,403	0.9%
Private Equity Distressed	DDJ Distressed Fund	57,392,526	5.1%
Private Equity Buy-Out	J.P. Morgan AIRRO Fund	17,317,257	1.5%
Total Private Equity		**124,976,536**	**11.1%**
Cash Equivalents	Cash Equivalents	20,925,889	1.9%
Total Cash Equivalents		**20,925,889**	**1.9%**
Total Portfolio		**$1,121,065,906**	**100.0%**

Source: College Illinois Investment Consultant’s June 30, 2011 report.

APPENDIX D

Agency Responses

Illinois
Student
Assistance
Commission

April 26, 2012

The Honorable William G. Holland
Auditor General of the State of Illinois
Iles Park Plaza
740 East Ash St.
Springfield, IL 62703-3154

Dear Auditor General Holland,

The Illinois Student Assistance Commission accepts all the recommendations made in the Management Audit of the College Illinois! Prepaid Tuition Program conducted by your office. Accompanying this letter is brief commentary around each recommendation.

As you know, ISAC is committed to mending the College Illinois! Prepaid Tuition Program and is actively working with a wide range of stakeholders to arrive at a holistic solution that best serves the program, contract holders and the State. It's important to note that most of the report's recommendations pertain to historical policies, practices and procedures that the new Commission and its staff have been working hard to improve. While we can't change the past, the recommendations made in this report will help guide ISAC as the agency addresses those areas requiring prompt remedial action and those where existing business processes can be enhanced.

ISAC is committed to doing both.

The report touches on many of the key milestones for the 6 year period between fiscal years 2006 and 2011. (Exhibit 1-1) However, many significant changes have occurred in the past nine months that have gone a long way towards resolving the issues identified in this report. I'd like to highlight just some of those developments as ISAC works to restore public confidence in the College Illinois! Prepaid Tuition Program.

- The Governor replaced the entire Commission Board, appointing a new Chair, Kym Hubbard;
- In January, ISAC certified to the Governor that the program has sufficient assets to meet all obligations for FY13;
- In late February, I joined the team as the new Executive Director;
- The agency employed a new General Counsel;
- We've hired a new Chief Investment Officer to manage the College Illinois! Trust Fund;
- A new Investment Committee and a new Audit Committee of the Commission Board were created and have already conducted multiple meetings;
- The Investment Advisory Panel was replaced with new members and has held two public meetings including an annual meeting with the Commission Board as required by statute; and
- ISAC retained a new investment advisor who, with our new CIO, is completing an asset allocation study that will inform the new Statement of Investment Policy.

That said, there is more that can and will be done to strengthen the program for current and future participants. Fortunately, we have some time to thoughtfully and purposefully consider a holistic approach to mend the program.

As noted above, in January ISAC submitted its annual certification to the Governor that the fund will maintain solvency for Fiscal Year 2013. College Illinois! continues to meet all of its financial obligations and is making tuition and fee payments to institutions in full and on time. Based on current actuarial assumptions, the program has sufficient assets to make tuition and fee payments until 2021-2022, even if no new contracts are sold.

Finally, I would like to recognize your audit team. While at times we had to agree to disagree, the process has been handled with the highest degree of professionalism and fairness, serving the intent of the General Assembly in House Resolution 174 and the interests of College Illinois! Prepaid Tuition Program contract holders and their beneficiaries.

Please feel free to contact me directly should you have any questions or require additional information.

Sincerely,

Eric Zarnikow
Executive Director
Illinois Student Assistance Commission

ILLINOIS STUDENT ASSISTANCE COMMISSION
RESPONSES TO
MANAGEMENT AUDIT OF THE
COLLEGE ILLINOIS!® PREPAID TUITION PROGRAM

#1 The Illinois Student Assistance Commission accepts this Recommendation.
Beginning with the appointment of the new Commission Board in July 2011, ISAC has begun to review and revise its organizational structure. The first step in this reorganization was hiring a new Chief Investment Officer and a new Executive Director, who began working in December 2011 and February 2012, respectively. As part of his new duties, the Executive Director is reviewing the College Illinois! organizational structure in keeping with this recommendation and will make any necessary changes to ensure operations are more cohesive and to increase accountability.

#2 The Illinois Student Assistance Commission accepts this Recommendation.
With the addition of its new Chief Investment Officer and the retention of its new Investment Advisor, in December 2011 and January 2012, respectively, ISAC is in the process of revising its investment policy for approval by the Commission Board at its June 2012 meeting. The new policy will more clearly define asset classes and include operational guidelines for each asset class. The Commission Board will be asked to approve a Statement of Investment Policy on at least an annual basis. Prior to submission to the Commission Board, the agency will seek advice from the Investment Advisory Panel as to the Statement of Investment Policy. The approval by the Investment Committee of the Commission Board will be obtained prior to consideration by the full Commission Board.

#3 The Illinois Student Assistance Commission accepts this Recommendation.
The Portfolio Committee, consisting of the Executive Director and Chief Investment Officer, conducted its first meeting on April 4, 2012, and will meet at least monthly going forward. The need for the Portfolio Committee, its makeup and its duties are under review. In the interim, the Investment Advisor will be asked to participate in future meetings. Any changes will be reflected in future amendments to the Statement of Investment Policy with advice from the Investment Advisory Panel. The Investment Committee of the Commission Board will be asked to approve changes to the Statement of Investment Policy prior to consideration by the full Commission Board.

#4 The Illinois Student Assistance Commission accepts this Recommendation.
The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval articulates the responsibilities of the Investment Committee of the Commission Board going forward. ISAC senior management is evaluating the best method(s) to communicate Investment Advisory Panel and Investment Committee proceedings to the Commission Board.

#5 The Illinois Student Assistance Commission accepts this Recommendation.
The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval articulates the responsibilities and statutory duties of the Investment Advisory Panel. In addition, the General Counsel, as ISAC's Compliance Officer, has undertaken the preparation of an annual checklist of items that must be complied with including, without limitation, ensuring compliance by the Investment Advisory Panel with its statutory duties.

#6 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC will comply with the Illinois Procurement Code in its selection of investment managers. Further, as of January 1, 2011, the process for procurement of investment managers is currently subject to review and approval by the Executive Ethics Commission's procurement officer assigned specifically to ISAC.

#7 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC will comply with the Illinois Procurement Code in its procurement of professional and artistic services. Further, as of January 1, 2011 the process for procurement of professional and artistic services is currently subject to review and approval by the Executive Ethics Commission's procurement officer assigned specifically to ISAC.

#8 The Illinois Student Assistance Commission accepts this Recommendation.
A new conflicts of interest policy will be presented to the Commission Board at its June 2012 meeting that will include appropriate disclosure requirements of potential conflicts of interest prior to procurement evaluation. The revised policy will also include investment restrictions related to potential or recent investments for any ISAC employee involved in the investment process as well as members of the Commission Board or Investment Advisory Panel. ISAC, through its Compliance Officer, will ensure that the policy is implemented and followed.

#9 The Illinois Student Assistance Commission accepts this Recommendation.
The Statement of Investment Policy to be presented to the Commission Board at its June 2012 meeting for approval will be revised to clarify ISAC's policy on direct private equity investments.

#10 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC has initiated a comprehensive review to ensure that all current and future position descriptions for College Illinois! employees clearly explain the duties, education, and professional experience required for the position. Additionally, ISAC will clearly document the duties performed by all employees whose work relates directly to the Program and are charged as direct payroll expenses. The agency will examine its terms and conditions of employment going forward.

#11 The Illinois Student Assistance Commission accepts this Recommendation.
As noted in the report, ISAC complies with all statutory requirements in the current form of the annual report. That said, the agency believes that increasing program transparency and the amount of information shared with current contract holders and future purchasers of College Illinois! contracts is vital in rebuilding and maintaining confidence in the Program. The agency has begun to post additional information, and on a more frequent basis, to both its primary websites: 529prepaidtuition.org and isac.org. ISAC is examining what other prepaid programs include in their annual reports with the intention of providing more information about contract sales, cancellations, tuition changes, schools beneficiaries are attending and more robust discussion of investment performance.

#12 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC will fully document assumptions used and how they were derived both in the annual actuarial valuation soundness report and in setting contract pricing.

#13 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC is reviewing its process for determining fees and charges to ensure that they are adequate and equitable. In addition, ISAC will clearly document how fees and charges affect the overall contract pricing structure.

#14 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC will examine its presentation of financial information to the Commission Board to ensure the information is offered in a clear and consistent manner, and submit budgeted values to actual expenses on a quarterly basis.

#15 The Illinois Student Assistance Commission accepts this Recommendation.
ISAC is reviewing its cost allocation policies and procedures to help ensure that they are consistent, transparent, and readily understandable.