



# Alternative Investment Funding Audit

#2021-04

August 25, 2021

## ERS Internal Audit Division

From the Director:

Internal Audit has completed its audit of Alternative Investment Funding at the Employees Retirement System of Texas.

Based on the audit scope areas reviewed, internal controls are effective and sustainable, and substantially address significant risks related to financial reporting reliability, operational execution, and regulatory compliance.

The organization's system of internal controls provides reasonable assurance that key goals and objectives will be achieved despite minor enhancements identified that would improve achievement of (control/business) objectives.

Other matters deemed less significant were communicated with management directly. We thank management and staff of the Finance and Investments division for their courtesy and cooperation extended to us throughout the audit project.

Sincerely,

**Anthony Chavez, CIA, CGAP, CRMA**

*Director, Internal Audit Division*

### Table of Contents

Objectives and Summary Results	2
Background	3
Observation	4
Scope and Methodology	5
Appendix A - Data Dashboard	6
Appendix B - Glossary	7

## Objectives and Summary Results

**Audit Objective:** To determine if contributions and distributions of funds for ERS' alternative investments are properly processed and accounted for.

**Overall Results:** Internal controls ensure capital is processed properly and accurately accounted for across relevant financial systems and parties. **(Satisfactory)**

SCOPE AREA	SUB-OBJECTIVES	RESULTS/RATING
<b>Processing</b>	<ul style="list-style-type: none"> <li>Are contributions submitted to eligible alternative investment/hedge fund?</li> <li>Are total contributions within agreed-upon limits (capital commitments)?</li> <li>Are capital contributions processed according to the contractual requirements?</li> </ul>	<p><b>Satisfactory</b></p> <p>Controls are in place to ensure capital contributions are accurately processed and wired to Funds in accordance with the contractual requirements, and that Total Commitment amounts are not exceeded.</p>
<b>Accounting</b>	<ul style="list-style-type: none"> <li>Are capital contributions/distributions accurately recorded in key financial/investment systems?</li> <li>Do fund balances accurately reflect capital contribution/distribution activity?</li> </ul>	<p><b>Satisfactory</b></p> <p>Controls ensure capital contributions/distributions are accurately recorded in key financial/investment systems, and reflect capital contribution/distribution activity.</p>

### Audit Rating Legend:

**Exemplary** - Effective, sustainable process

**Satisfactory** - Internal controls effective and working as intended

**Needs Improvement** - Internal controls partially effective

**Unsatisfactory** - Entire control framework in need of repair

## Background

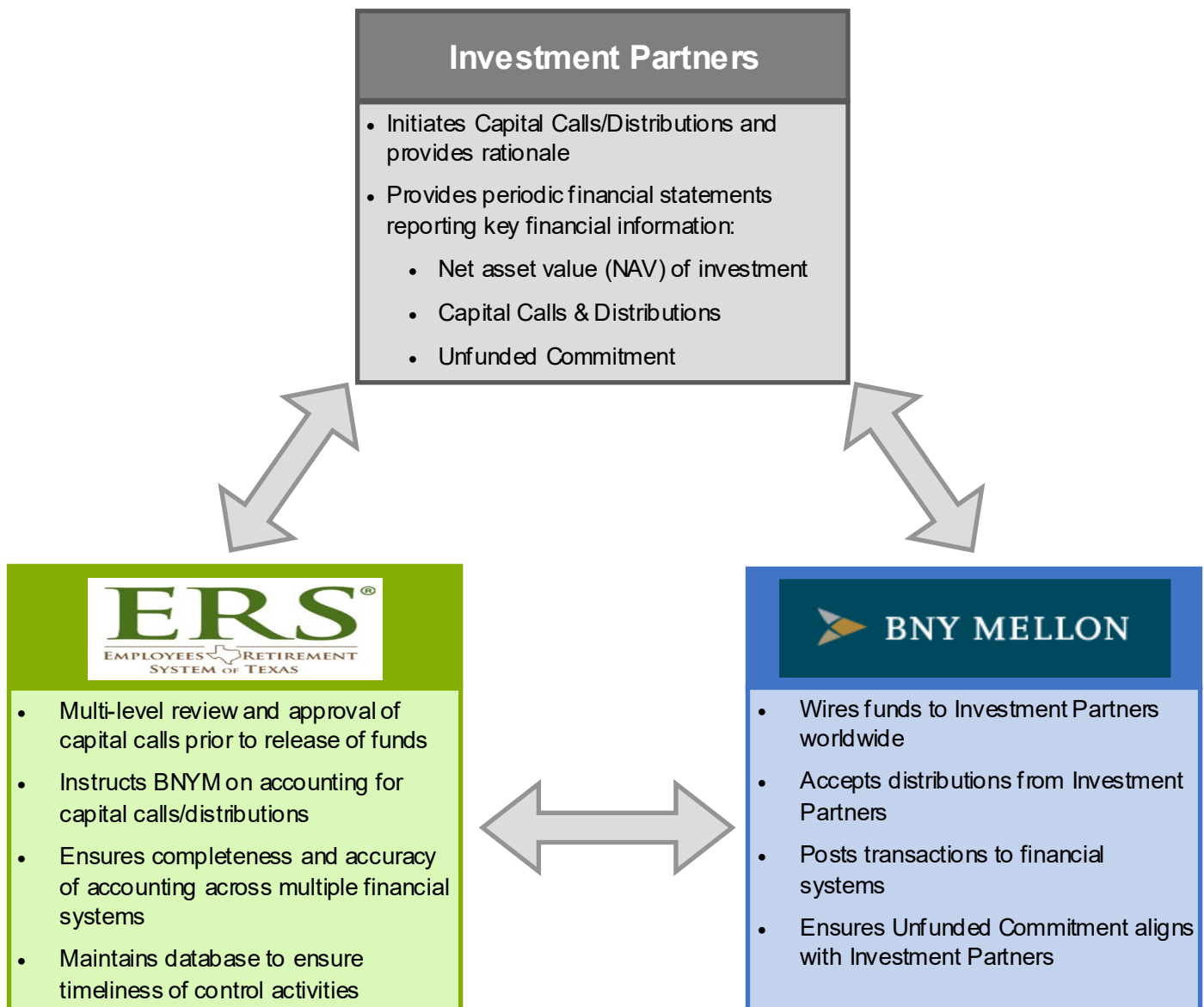
For alternative investments, ERS commits funds (**Committed Capital**) to **Investment Partners** for investments in private equity, private real estate, private infrastructure, private fixed income and hedge funds. ERS' Investment Partners consist of both General Partners (GP) in alternative investments and hedge fund managers. These partners select investments to pursue and determine when Capital Calls will occur. As of March 31, 2021, ERS has invested over \$12.44 billion in alternative investments across 317 active investments. (See **Appendix A** for further detail.)

Typically total committed capital will not be invested immediately or all at once, but rather drawn over time as investments are identified by GPs. These drawdowns are commonly referred to as **Capital Calls**, and are initiated by GPs when a new investment is to be made and funding is needed. The frequency, amount, and timing of Capital Calls will vary at the discretion of the GPs. (See **Transaction Activity on Page 4**)

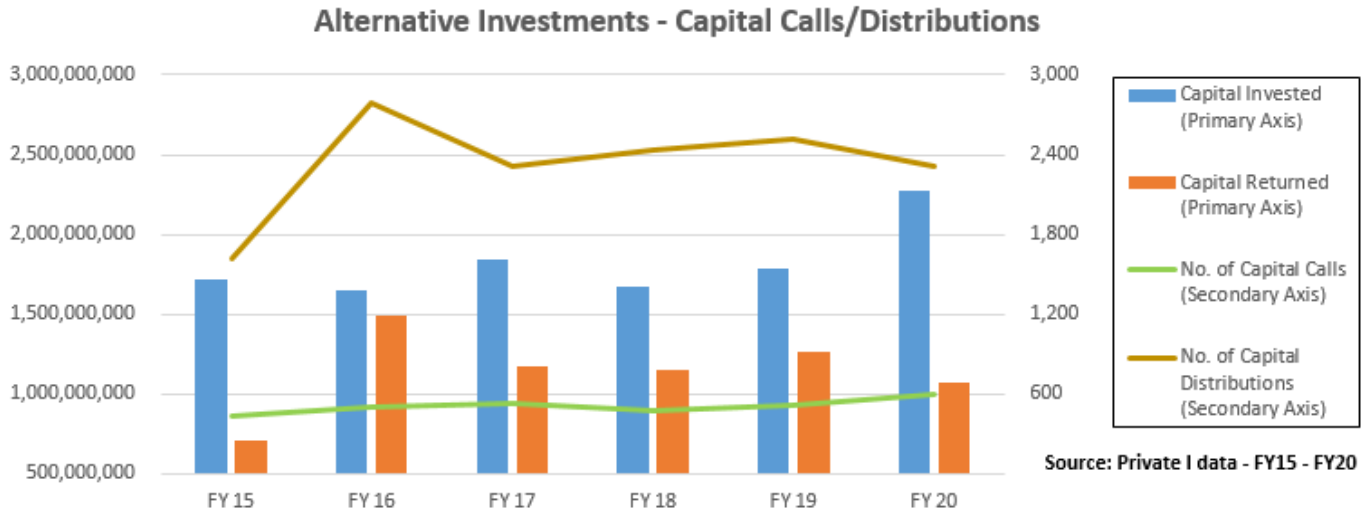
As the investments mature, **Capital Distributions** are made to return the capital ERS has invested, as well as any Income and Capital Gains/Losses.

Investment partners also provide ERS and ERS' **Investment Custodian, BNY Mellon**, with periodic reports of the accounting for the investment fund, including a calculation of **Unfunded Commitment**. This Unfunded Commitment is used by all three parties to ensure the accounting for the capital in the fund is complete and accurate.

For further definition of all **bolded** terms, see the **Glossary** in **Appendix B**.



## Alternative Investment Transaction Activity



### Observation: Key controls are in place to meet program objectives.

Testing confirmed the design and effectiveness of key controls ensure the proper processing and accurate accounting for capital in the alternative investment.

#### INHERENT RISKS

- Capital sent to wrong investment partner
- Capital sent to entity not an investment partner
- Capital contributed exceeds commitment amount
- Capital not provided per investment partner's instructions
- Capital inaccurately accounted for across multiple financial/investment systems

#### KEY CONTROLS

- Multi-level review and approval of capital calls prior to release of funds
- Custom payment template for each investment to ensure accuracy of wiring instructions
- ERS instructs custodian on accounting for capital calls/distributions for consistency and accuracy
- Multiple reconciliations to ensure completeness and accuracy of accounting across all financial systems
- Reconciliation database to track completion of control activities

## Scope and Methodology

We performed this audit in accordance with the FY21 annual audit plan. Internal control activities reviewed include those in place from September 1, 2019 through March 31, 2021.

We conducted this audit in accordance with Generally Accepted Government Auditing Standards and in conformance with the International Standards for the Professional Practice of Internal Auditing. 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.

A defined set of control objectives was utilized to focus on operational goals for the identified scope. The Committee of Sponsoring Organizations of the Treadway Commission Internal Control Integrated Framework was the basis for internal control assessment. Our Internal Audit opinion is an assessment of the condition of the overall control environment based on the effectiveness of internal control activities through the audit period and the degree to which defined control objectives are being met. Our Internal Audit opinion is not a guarantee of operational effectiveness or regulatory compliance, particularly in areas not included in the scope of this audit.

This audit included a review of internal controls considered relevant to audit objectives including review of statutes, policies and procedures, interviews with management and team members, data analysis, and testing procedures.

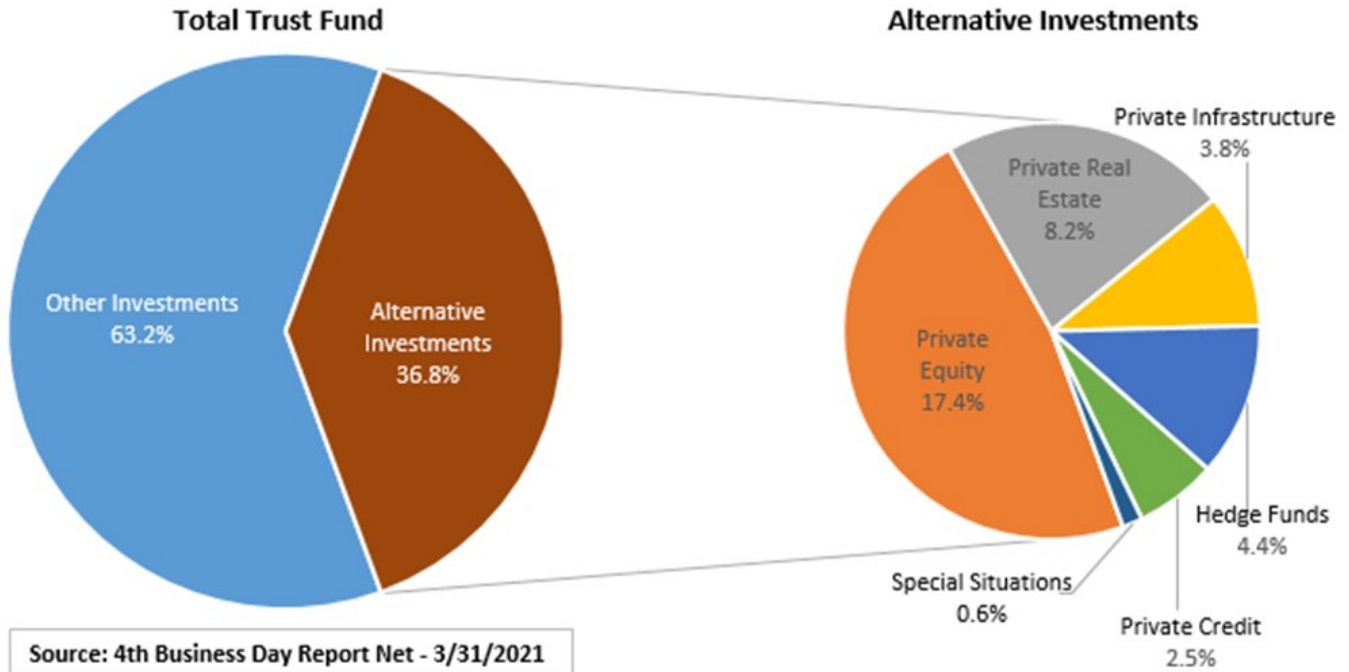
## Related Audits

- Management Fees Audit (2018-09)
- Profit Share Audit (2019-08)

## Appendix A: Data Dashboard

The chart below shows the percentage of the Total Trust Fund as calculated for each asset class.

### Alternative Investments as part of Total Trust



The table below shows the net asset value of each alternative investment asset class, and the percentage of the Total Trust Fund, as of 3/31/2021.

Asset Class	Investment Amount	% of Trust Fund
Other Investments	19,581,095,565	63.2%
Private Equity	5,901,110,449	17.4%
Private Real Estate	2,775,056,198	8.2%
Private Infrastructure	1,299,312,467	3.8%
Hedge Funds	1,483,685,142	4.4%
Private Credit	789,559,982	2.5%
Special Situations	193,219,480	0.6%
<b>Total</b>	<b>12,441,943,718</b>	<b>100.0%</b>

## Appendix B: Glossary

**Bank of New York Mellon (or BNYM)** - ERS' Investment Custodian (see Investment Custodian below).

**Capital Call** - occurs when an Investment Partner requests all or a portion of the Capital Commitment from partners for funding investments.

**Capital Commitment (also Committed Capital)** - the amount of money ERS has agreed to invest with an investment partner in the Alternative Investments or Hedge Fund asset classes.

**Capital Distribution** - occurs as investments mature and the Investment Partner returns capital, fees, expenses, Income, and/or Capital Gains to ERS.

**Investment Custodian** - ERS' 'bank' in which all investment funds are held and accounted for. The custodian provides secure methods for sending and receiving funds to/from investment partners worldwide, and an independent accounting of all incoming and outgoing funds. The custodian provides additional services including the independent calculation of Investment performance.

**Total Commitment** - the total amount of money ERS has committed to the investment partner, and represents the total amount ERS should have at risk in any particular alternative investment.

**Unfunded Commitment** - the portion of the Total Commitment ERS is still liable for if the investment partner calls in all available committed capital. The amount is calculated by subtracting any previously contributed capital from the Total Commitment. Unfunded Commitment is used by ERS and BNYM to ensure the accuracy and completeness of the accounting for the capital in each alternative investment.