Audit Committee Meeting Minutes
December 10, 2019

ERS
Employees Retirement System of Texas

Presented for Review and Approval
March 11, 2020

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AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS
December 10, 2019
TRS Board Room, E513
TRS Building - 1000 Red River Street
Austin, Texas 78701

TRUSTEES PRESENT
Catherine Melvin, Audit Chair
Brian Barth, Member
Ilesa Daniels, Member
I. Craig Hester, Member
Dr. James Kee, Member

ERS DIRECTORS PRESENT
Porter Wilson, Executive Director
Cathy Terrell, Deputy Executive Director
Paula A. Jones, Deputy Executive Director & General Counsel
William Nail, Special Projects & Policy Advisor
Jennifer Chambers, Director of Government Relations
Tony Chavez, Director of Internal Audit
Bernie Hajovsky, Director of Enterprise Planning Office
Robin Hardaway, Director of Customer Benefits
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director of Procurement and Contract Oversight
Dee Dee Sterns, Director of Human Resources
Kathryn Tesar, Director of Benefits Communications
Tom Tull, Chief Investment Officer
Chuck Turner, Chief Information Officer
Keith Yawn, Director of Strategic Initiatives

ERS STAFF PRESENT
Jason Avants, Information Systems
Kelley Davenport, Executive Office
Juli Davila, Investments
Pablo de la Sierra, Investments
Courtney Dunn, Investments
Aaron Ismail, Internal Audit
Tressie Landry, Internal Audit
Ricky Lyra, Investments
Greg Magness, Internal Audit
Betty Martin, Investments
Roger Nooner, Benefits Communications
Karen Norman, Internal Audit
Jamey Pauley, Enterprise Planning Office
Susie Ramirez, Executive Office
Tanna Ridgway, Investments
Robert Sessa, Investments
Mary Jane Wardlow, Executive Office

ALSO PRESENT
Morgan Burandt, State Auditor's Office
Hillary Eckford, State Auditor's Office
Andrea Focht-Williams, Texas Municipal Retirement System
Colleen McGlamry, UnitedHealthcare

Meeting of the ERS Board of Trustees' Audit Committee

1. CALL TO ORDER

1.1 Call Meeting of the ERS Board of Trustees' Audit Committee to Order

Ms. Catherine Melvin, Chair of the Board of Trustees Audit Committee of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order at 9:00 a.m. and read the following statement:

"A public notice of the ERS Board of Trustees Audit Committee meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State 10:50 a.m. on Monday December 2, 2019, as required by Chapter 551 Texas Government Code, referred to as the Open Meetings Law."

2. MINUTES

2.1 Review and Approval of the Minutes to the August 21, 2019 ERS Audit Committee Meeting – (ACTION)

Ms. Melvin opened the floor for a motion on the approval of the minutes from the August 21, 2019 ERS Audit Committee meeting.

The Board then took the following action:

Move that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes to the meeting held on August 21, 2019.

Motion by Craig Hester, second by Jim Kee
Final Resolution: Motion Carries
Aye: Craig Hester, Doug Danzeiser, Ilesa Daniels, Catherine Melvin, Jim Kee

3. AUDIT ITEMS

3.1 Review of External Audit Reports

Mr. Tony Chavez, Director of Internal Audit, introduced Hillary Eckford and Morgan Burandt with the State Auditor's Office (SAO) to present their Annual Incentive Compensation Audit performed on four agencies issued in August.

Mr. Burandt described the issue ratings used by the State Auditor's Office and stated that ERS obtained a rating which indicates that the auditors believe that ERS has the ability to administer the Incentive Compensation Program (ICP) successfully. The auditors found that ERS calculated incentive compensation in accordance with most of its policies and procedures. There were a few recommendations, first is to strengthen the controls over the review process for calculating awards. Secondly, some changes in calculation methodology were not communicated to executive management. Thirdly, since converting the calculation process to a database, the agency has not finalized updates to the documented policies and procedures of the program and they are still in draft form.

Ms. Melvin asked if there was anything the auditors felt that the board should know that is not already in the audit. Ms. Eckford responded that everything they feel important was included in the report.

Mr. Chavez thanked the state auditors and invited DeeDee Sterns, Human Resources Director, and Jamey Pauley, Program Specialist, to discuss changes made to the program since the issuance of the report.

Mr. Pauley reviewed a few of the significant changes made to the program:

- The ICP payment date moved from December 1 to February 1 to provide more time for due diligence

- Moved responsibility for the investment performance calculations from Investment Services to Finance
- Implemented a formal change management process for tracking changes and standardizing necessary approvals
- Partnered with our third-party reviewer to have them perform additional, smaller scale verifications for changes or corrections that occur after they've done their intensive verification in the fall
- Updated procedures to reflect current policy and practice and developed a detailed timeline and task list

Ms. Sterns noted that Human Resources has administrative oversight responsibilities for the ICP and stated that the agency is committed to 100% error free calculations and payment processing. She noted that in addition to the changes noted by Mr. Pauley, they will continue to monitor the program with continual evaluation for appropriateness.

Mr. Pauley and Ms. Sterns clarified that changing the calculation responsibility to Finance began with the 2019 plan year payments. Finance performs the payment calculations and Human Resources partners with a contracted third-party vendor to validate those calculations.

There were no questions or further discussion, and no action was required on this item.

3.2 Review of Internal Audit Reports

Mr. Tony Chavez, Director of Internal Audit, informed the board of one completed engagement: Audit of Profit Share. Mr. Chavez introduced Tressie Landry, audit manager, and Greg Magness, audit lead.

Mr. Magness stated that the audit covered the processes in place to calculate, track, and report profit share distributed to ERS investment partners. Beginning September 1, 2017, ERS was required to build a formal model, based on best practices and industry standards, to calculate, track and report profit share by asset class. This is the only requirement for ERS to report these costs in our annual financial report, as the Government Accounting Standards Board has remained silent regarding these costs. Prior to this, ERS had informal processes in place to verify and track profit share.

Profit share is earned by our investment partners for returns exceeding agreed-upon performance. The better an investment performs the more profit the manager can earn. Before a manager can earn profit share, they must return certain costs to ERS and meet investment thresholds. For instance, an agreement may specifiy that any profit above an 8% return will be split in some manner between ERS and the manager. Profit share is also referred to as carried interest in the alternative investment world. However, the legislature defined profit share to include incentive fees, performance fees, and carried interest. Therefore, amounts distributed to hedge fund managers and external investment advisors are also included in this report.

The Institutional Limited Partners Association (ILPA), of which ERS is a member, is considered an industry leader in working on transparency and reporting in the private equity industry. They have developed a set of principles to guide the discussion between general partners and the investors entering into these investments. They have defined three guiding principles of an effective private equity partnership as:

- the alignment of interests between the general partner and the investors,
- governance of the fund or the partnership, and
- transparency in the information that is reported on the investments, as well as fees and expenses.

According to ILPA, profit sharing is one of the best ways to align that interest between the general partner and the investors. ERS implemented the requirements immediately, including the amounts of profit share that were distributed in FY17 in that year's annual financial report. From there, staff began developing a control framework to ensure compliance with the statute going forward. While the amounts are significant, they are based on performance above agreed-upon criteria. As ERS has sought to diversify the investments of the trust fund these represent the cost of entering into these types of investments.

In order to show the development of this program, a timeline is included as in the report which shows the progression of ERS' monitoring and reporting of these costs.Processes have now been automated and formalized to include ERS' re-calculation of the profit share to ensure accuracy.

Mr. Magness clarified for Mr. Hester that only the Hedge Fund profit share is re-calculated by a third-party.

The overall assessment for the audit was satisfactory for both scope areas: profit share formation and profit share reporting. There were two observations that will be discussed, but first Mr. Magness covered the various methodologies used by the asset classes to verify profit share, all of which are based on best practices. These include:

- using a third-party to verify profit share calculations (hedge funds asset class)
- perform desk reviews of the calculation methodology used by the general partner (private real estate asset class)
- internal re-calculation (private equity asset class)

In the future, the Finance division will internally verify profit share calculations for private real estate, private infrastructure, and private fixed income asset classes in addition to the private equity.

Mr. Hester acknowledged that profit share is a complex and complicated process for all asset classes and asked for the number of different partnerships included in these asset classes. Mr. Magness reported that there are 150 partnerships just for private equity, and he would need assistance with specific numbers for the other asset classes, but he estimates around 300 partnerships. Most general partners send statements quarterly. Mr. Hester calculated that would be around 1,200 basic fee statements per year and inquired about the size of staff dedicated to performing the re-calculations. Mr. Magness reported that there are three individuals, each assigned an asset class, (except hedge funds, which is re-calculated by the consultant) in the investment accounting department of the Finance division.

Mr. Magness stated that any discrepancies are addressed by the portfolio managers working with the general partners. Occassionally a member of the finance team has to follow-up with the general partner to obtain information needed for the re-calculation. Mr. Chavez stated that this addresses observation two in the report, where it is more of an evolution of the program. Right now, there is a framework to identify variances and the next maturation would be to have an escalation process when there are differences between the accountant's re-calculation and the general partner's calculation.

Mr. Magness continued the discussion about the first observation, stating there were control gaps defined by both process owners and auditors that led to improvements in efficiency and completeness of reporting:

- Private real estate – as some profit share amounts were not included in the consolidated annual financial report, a formalized reconciliation process was implemented
- Hedge funds – reporting procedures have been automated, however, an issue with timing meant that amounts reported in July and August would never be included. Going forward, the reporting period will be adjusted to include all 12 months.

The second observation relates to maturing the program to include an escalation process for the accountants re-calculating profit share distributions. Internal Audit recommends that portfolio managers be part of the re-calculation process when discrepancies exist since they are ultimately responsible for the portfolio and issues encountered by the accountants should be considered in their management of the investment.

Mr. Chavez noted that this addresses Dr. Kee's question from earlier – the decision maker or portfolio managers, who understand all the investments in their portfolio, would be best to determine how to handle discrepancies.

Mr. Barth inquired about the frequency and size of variances. Mr. Magness reported that in his testing, he did not see one that reconciled to the penny, and all but one were within the tolerable variance of 10%. Mr. Chavez added further that some differences are inherent to the process due to complexity or timing and these issues are not unique to ERS. One of the reasons ILPA was created was to begin establishing best practices, and as mentioned earlier, ERS is a member organization.

Ms. Melvin asked if the ERS Investment Compliance Officer could assist in the review of the numerous statements. Mr. Chavez believes that the current framework in existence is sufficient to handle the workload, but it will be something that ERS should continue to evaluate. He referred to Appendix C of the report which outlines some significant components of profit share. Every agreement is different for each of these components, making each re-calculation unique to that agreement. In his opinion, he thinks this is more of an accounting and tracking function and something that the portfolio managers should be actively testing and managing, but there could be some oversight from investment compliance.

Mr. Magness continued with the remaining recommendations highlighting the need to share information between divisions to increase efficiencies. Increased communication between the legal and finance divisions and asking the portfolio managers and teams to share investor-level reporting with the accounting team would reduce asking for the same information. Finally, additional effort should be made to ensure the system of record for tracking profit share amounts be kept up-to-date so that historical information is accurate and information reported in agency financial statements is supported.

There were no questions or further discussion, and no action was required on this item.

3.3 Review of Internal Audit Administrative Items

Mr. Chavez stated that this is the time of year where Internal Audit performs an annual performance and quality review in compliance with professional standards. This year the office was due for an external peer review, which was conducted by Sonya Etheridge, Director of Internal Audit at the Texas Facilities Commission, and Andrea Focht-Williams, Senior Auditor at the Texas Municipal Retirement System.

Mr. Chavez explained that there are three reports related to this agenda item – the peer review report, internal audit annual report, and internal audit performance measures. The external peer review is only completed once every three years, an internal self-assessment is performed in the other years. The peer review is required by government auditing standards and is governed by procedures developed by the Texas State Agency Internal Audit Forum. There are three ratings the peer reviewers can assign – generally conforms or pass, pass with deficiencies, or not pass. The peer review team reviews Internal Audit's policies and procedures, interviews members of the board, reviews prior self-assessments and interviews members of executive management and internal audit staff. They also review a sample of engagements to ensure the work papers are compliant with professional standards.

Mr. Chavez invited Ms. Etheridge to present the results of the review. Ms. Etheridge stated that, in their opinion, internal audit passed the review with the rating of pass/generally conforms. She then noted some best practices identified by the peer review team:

- Articulates the level and extent of risk when communicating results
- Mid-audit update (scope) meetings with stakeholders and program owners
- Staff attend relevant and timely training

Mr. Hester asked if there were any recommendations to the Board for opportunities or areas of improvement. Ms. Etheridge stated that there were some observations that were shared with Mr. Chavez that he will review in his presentation, but the most significant information is that the office passed and has the controls in place to conform with standards.

Mr. Chavez then presented information related to the internal audit annual review and performance measures. Internal Audit focuses on three strategic objectives and results for each:

- Enhance professional practices
    - The internal audit function has controls in place to comply with professional practices.

    - Areas of improvement include documentation of required communication in consulting engagements, timeliness of review, data validation and analysis, and incorporating more formal documentation information technology risks.
- Enhance performance management and accountability
    - From the stakeholder (executive and senior management) survey: the perception of internal audit within ERS is good and management believes internal audit addresses significant risks, but believe recommendations could be improved to address root cause and information technology proficiency of auditors could be improved.
- Grow people management
    - A staff skills assessment showed that there is alignment between self-assessments and the Director's assessment, the staff is ethical, knows the standards and knows the business.
    - Training this past year was real time with two engagement leads getting relevant training right before or during the engagement. Auditors also attended the Association of Public Pension Fund Auditors Conference, which is an association of just public pension fund auditors. In addition, one staff member attended the Internal Audit Leadership Development Program and Internal Audit lead interns from the University of Texas at Austin on some ERS project work.

Mr. Chavez showed results of a question on the stakeholder survey which asked respondents to rate the maturity level of the ERS internal audit program. Respondents could select from five responses/stages, with "Initial Stage" being the lowest rating and "Controlling/Optimized Stage" being the highest. A total of 44% of the respondents said that it was integrated and all said it was integrated or higher (the Integrated Stage is the third stage in the maturity scale). This information was useful to Mr. Chavez in evaluating whether the internal audit function is adding value.

Dr. Kee asked about the lowest rated performance measure on the self-assessment, Percent of Audits within Audit Engagement Budgeted Hours, and how measures that do not meet their targets get focused on for improvement. Mr. Chavez explained that there was actually improvement in the second half of the year on that measure. This will always be a challenge though because it is a balance between completing the engagement and taking the time to provide extra value and be innovative during the engagements.

Ms. Melvin emphasized that quality must be the first priority and challenged Mr. Chavez to think about developing more measures or additional measures to measure quality, acknowledging that as an internal audit director herself it is a challenge to find measures of audit quality. Mr. Chavez noted recent discussions about this topic and that there are two performance measures that address quality for him – the percent of recommendations accepted by management and the number of days from end of fieldwork to draft report sent to the executive director. The number of recommendations accepted by management measures quality through acceptance that the work was adequately supported and accurate. Management can disagree with the recommendations. The second measure incorporates those standard audit milestone meetings, one of which is the end of fieldwork meeting when results are presented. If the time between finalizing the observations and the time the executive director gets the report is significant, it would show that the audit was not ready at the end of fieldwork, or maybe there was significant disagreement on the findings.

Mr. Barth asked about two 2019 strategic objectives, groom staff for leadership roles and decrease reliance on individual(s) – that he didn't see specifically addressed in the presentation. Mr. Chavez stated that those have been improved and would be addressed under the Grow People Management strategic objective. These are wrapped in the skills assessment performed in 2019 and the training. Mr. Chavez noted that a few years ago he was challenged with decreasing reliance and building more sustainability in processes, which has been accomplished more behind the scenes.

There were no questions or further discussion, and no action was required on this item.

4. ADJOURNMENT

4.1 Adjournment of the ERS Board of Trustees Audit Committee meeting. Following adjournment of the Audit Committee, the Board of Trustees will take up the remining Board agenda items.

The Audit Committee adjourned at 10:13 a.m. on December 10, 2019