



Ethics Audit

#2023-05

March 20, 2023

From the Director:

Internal Audit has completed its Ethics Audit at the Employees Retirement System of Texas.

Based on the audit scope areas reviewed, the system of internal controls partially addresses significant risks related to operational execution. Control gap corrections and improvement opportunities were identified, including:

1. Roles and responsibilities not formally identified and communicated. (Significant)
2. Ethics Policy does not fully address all ethics activities and promote understandability. (Significant)

Other matters deemed less significant were communicated to management directly. We thank management and staff of the Human Resources, Office of General Counsel, Executive Office, and the Office of Procurement and Contracting divisions for their courtesy and cooperation extended to us during the engagement.

Sincerely,

Anthony Chavez, CIA, CGAP, CRMA

Director, Internal Audit Division



ERS Internal Audit Division

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Objectives and Summary Results

Audit Objective: Determine if the ERS Employee Ethics Policy aligns with regulatory requirements and effectively communicates expectations and responsibilities.

Overall Results: The Ethics Policy incorporates essential components, but improvements could be made in both form and content to enhance effectiveness. **(Needs Improvement)**

SCOPE AREA	SUB-OBJECTIVES		RESULTS/RATING
Policy Communication	<ul style="list-style-type: none"> Is the Ethics Policy structured and organized to promote ease of understanding and finding of relevant information? Is language used to promote ease of understanding by employees regardless of level of expertise? Is Ethics Policy readily accessible and circulated to all employees? 	Needs Improvement	<p>The policy is accessible, but is not presented as a cohesive document.</p> <p>(See Observation 2)</p>
Policy Composition	<ul style="list-style-type: none"> Is Policy aligned with all required regulatory regulations? Does Policy include all necessary components? Is Policy consistent as to applicability of ethic standards for all employees? Does the Ethics Policy include clear reporting and protection mechanisms for employees? 	Satisfactory	<ul style="list-style-type: none"> All requirements are included. Policy document does not fully address some key components. <p>(See Observation 2)</p>
Policy Governance	<ul style="list-style-type: none"> Are roles and responsibilities for the implementation and compliance clear for each function of the program? Is the policy regularly reviewed to ensure it strikes a balance between providing comprehensive guidance and remaining user-friendly? Are updates consistent with ERS version control practices? 	Needs Improvement	<p>Roles and responsibilities have not been established.</p> <p>(See Observation 1)</p>

Audit Rating Legend:

Exemplary - Effective, sustainable process

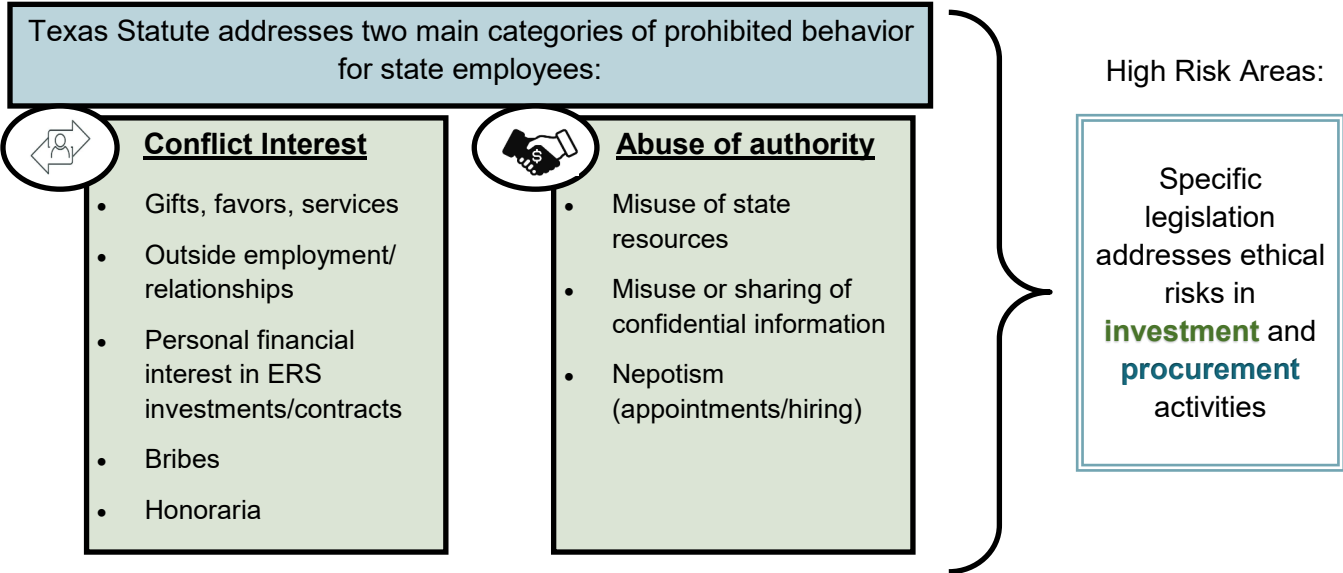
Satisfactory - Internal controls effective and working as intended

Needs Improvement - Internal controls partially effective

Unsatisfactory - Entire control framework in need of repair

Background - Texas State Ethics

Ethics are the principles that guide how individuals behave and conduct their activities. Texas statute establishes standards of conduct for all state employees, of which the primary guidance is employees should make decisions that benefit the State (ERS) first, not their own personal financial benefit. In addition to state employees, statute requires other stakeholders, including board members and vendors, to also abide by ethical behavior requirements.



Investments and Procurements

ERS is one of the few agencies tasked with investing funds, carrying fiduciary responsibilities as well as awarding several large dollar contracts for investments and healthcare.

Statute prohibits certain activities related to investments and procurement and mandates ERS create disclosures to demonstrate compliance.

As a **fiduciary** ERS holds a legal and ethical relationship of **TRUST**

Ethics Program Framework

In coordination with key stakeholders an Ethics Program framework was developed to identify all ethic related activities at ERS. The scope of this audit engagement focused on **ERS Employee Ethics Policy**.

Governance	Compliance
<ul style="list-style-type: none"> • Policy • Leadership • Education • Reporting Mechanisms 	<ul style="list-style-type: none"> • Disclosures • Affirmations • Investigations • Program Reporting

Observation 1: Roles and responsibilities not formally identified and communicated. (Significant)

Program Risk:	<ul style="list-style-type: none"> • Ethics Program activities may not be performed or inconsistently performed as intended. • Loss of trust from external stakeholders.
Inherent Risk:	<ul style="list-style-type: none"> • Multiple individuals across different ERS divisions contribute to the governance and enforcement of the Ethics Program. • Ethics Program activities generally performed intermittently and not part of daily/primary responsibilities. • Highly visible program with strong Legislative interest/regulatory requirements. • Select ERS program areas have regulatory compliance requirements in addition to standard (agency-wide) Ethic requirements. • Increased legal obligations as a fiduciary.
Background:	<ul style="list-style-type: none"> • Effective documentation of internal controls includes establishing and communicating the who, what, when, where, and why of internal control execution to personnel. ¹ • Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives. • Specifying roles and responsibilities promotes transparency within the organization by making it clear how decision are made and who is involved in the ethics program. <ul style="list-style-type: none"> • Transparency builds trust among stakeholders and demonstrates a commitment to ethical conduct. • A RACI matrix is a tool that helps ensure all facets of a program are accounted for and clearly communicated. This matrix includes tasks to be completed, responsible parties, and the identification of varying roles for each party. (See Appendix B)
Control Observations:	<ul style="list-style-type: none"> • Roles and responsibilities for the Ethics program have not been formally defined, including formal designation of the following program activities: <ul style="list-style-type: none"> • Policy development • Policy review/approval • Program governance reporting (to Board/Executive Office) • Ethics investigations • Ownership of internal violation reporting link • Ambiguity exists as to roles referenced in current Ethics Policy. ERS General Counsel is also the Chief Compliance Officer and Ethics Advisor. However the associated responsibilities for each respective role, if any, could not be determined. • Although verbally communicated General Counsel is the owner of the Ethics Policy it could not be determined the responsibilities as policy owner. ERS Ethics Policy is a sub-section within the ERS Personnel Policy and Procedure Manual which is administered by the Human Resources Division (HR). The responsibilities of the HR Director for ERS Ethics Policy, if any, was not formally defined. • See Observation #2 for further details related to ERS Ethics Policy.

¹ United States Government Accountability Office, Standards for Internal Control in the Federal Government, Section 3.10

Recommendation:

To improve the ethics program for ERS, management should clearly define roles and responsibilities related to the ethics program.

Management Action Plan:

Management agrees that clarifying roles and responsibilities for ethics policy development, education and enforcement would be beneficial. The team will document ownership of the policy document and other functions. Discussion will consider if creating and seeking approval for an Ethics Officer is warranted. Management expects to have the documentation complete by the end of Fiscal Year 24.

Management Action Plan

Responsible Position: Deputy Executive Director

Implementation Date: August 2024

Observation 2: Ethics Policy does not fully address all ethics activities and promote understandability. (Significant)

Program Risk:	<ul style="list-style-type: none">• Employees unintentionally violate policy due to misunderstanding of expectations.• Loss of trust in the process/disengagement from internal stakeholders.
Inherent Risk:	<ul style="list-style-type: none">• No standard ethics policy template, each agency must develop their own based on applicable guidance.• Policy must be understandable to over 400 employees in various positions and roles.• Select compliance requirements only applicable to certain roles.
Background:	<ul style="list-style-type: none">• Significant legislative interest related to Texas' Ethics including multiple statutes addressing ethical standards and behavior particularly related to Texas investments and contracting (<i>See Appendix C</i>).• Guidance has been developed by three state agencies (<i>Texas Ethics Commission, Pension Review Board and the Office of the Attorney General</i>) to assist other agencies in developing their own ethics policy. Although guidance provided is not required to be incorporated, it is best practice. (<i>See Appendix D</i>)• Management is responsible for designing policies and procedures to align with organizational objectives and circumstances and establish them as an integral part of operations (internal controls).• Management is responsible for communicating information (policy), including objectives and responsibilities for internal control, necessary to support the functioning of internal control.• ERS Style Guide provides guidelines to improve readability and understanding of ERS communications.• ERS Ethics Policy and Related Information (Policy) was created by merging the Ethics Policy from the Human Resources Personnel Policy and several divisional, ethics related documents.

Policy Best Practices:

The following attributes were reviewed to evaluate the **Policy**:

Comprehensiveness - all ethical issues relevant to ERS are included in Policy

Clarity - policy is written and organized to promote understandability by all employees, regardless of their level of expertise

Communication - the policy and changes are clearly communicated through various channels and are readily accessible to all employees

ERS Ethics Policy and Related Information (**Policy**) was evaluated to assess clarity, relevance, and ability to guide ethical behavior within ERS. The following observations were identified:

Comprehensiveness

- Limited reference to whistleblower (non-retaliation) protections. Although mentioned twice in Policy no description of expectations and process provided. In addition references embedded within paragraphs and not a stand-alone section in the Policy increases risk a reader may not be aware protections exist.
- No description of the investigation process for reports of suspected ethics violations. Although Policy states reported ethics violations will be investigated it does not provide details as to responsible parties for investigations, the due-diligence to be conducted and final disposition including individual(s) responsible for final disposition or notification back to reporter. Limited transparency into the investigation process increases the likelihood employees may not trust the process.
- No detailed requests for information prompted when submitting suspected ethics violation through ERS' Intranet. The current Ethics violation link includes one open-ended prompt stating *"Please provide as much detail as possible."* A similar link on ERS public website includes prompts to report individuals involved, suspected violation, time period and potential witnesses. Both links allow for anonymity. Sufficient information is needed to conduct a proper investigation.
- No Policy requirement for Board reporting to update on effectiveness and results of ERS Ethics Program. Board reports could include summary information of employee reported ethics allegation results to promote transparency. In addition, the availability of data currently collected does not support the reporting summary results.

Control Observations:

Clarity

- No single comprehensive and cohesive policy document. Current Policy is a fragmented grouping of multiple ethics related documents combined in a single location to improve accessibility (communication).
- Policy document follows a division-based organization, presenting distinct sections for each division. This structure implies that each division has its own set of policies. Despite certain individuals being subject to additional ethics compliance requirements, such as conflict of interest disclosures, non-disclosure agreements and personal trading approvals, the standards of ethical conduct and expectations are consistent for all ERS employees.
- Single location grouping of documents resulted in repetitive information being communicated.
- Policy not aligned with ERS Style Guide practices to promote readability including:
 - ◇ Current readability is at a 16th grade-level. Target readability is at an eighth-grade level.
 - ◇ Relatively higher (22%) passive voice writing. Although no target active/passive voice percentage noted by Style Guide, a higher active voice percentage is clearer and more engaging.
 - ◇ Multiple font size and type vary used in Policy.

Recommendation:

Once an Ethics Policy Owner is identified, the Policy Owner should review and edit the Ethics Policy to enhance clarity, consistency, and emphasis, as well as to include investigation steps. Additionally, related reporting mechanisms should be updated to include additional questions and monitored to ensure consistent functionality.

Management Action Plan:

Although recent work has been completed on the ethics policy which addresses the comment related to the look and design of the policy, management agrees that further clarification and consolidation would make the policy more relevant to employees. Management expects a review of the policy to be completed by September 30, 2024.

Management Action Plan

Responsible Position: Deputy Executive Director

Implementation Date: September 2024

Scope and Methodology

We performed this audit in accordance with the FY23 annual audit plan. Internal control activities reviewed include those in place for the ERS Ethics Program from FY23 up to the time of audit fieldwork testing which ended in February 2024.

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.

The Director of Internal Audit participates in the triage of reported ethics violations, assisting in making the determination if a reported violation should be investigated and by whom. In addition, the Investment Compliance Officer directly reports to the Director of Internal Audit and during the term of this engagement the Internal Audit Manager was acting in the capacity of the Investment Compliance Officer in relation to ethics compliance. No testing was performed in this engagement over the appropriateness of investigations or the investigative process or the ethics compliance tasks related to the Investment Compliance function.

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 staff, data analysis and testing procedures.

Related Audits

- 2017-02 Ethics Audit

Appendix A: Key Controls



Risk:	Management fails to create good ethical culture.
Key	ERS includes additional questions on the Survey of Employee Engagement to assess the ethical environment.
Controls:	2022 Survey of Employee Engagement ERS had an ethics score of 4.29 out of 5.00.



Risk:	Allegations not reported for fear of retaliation.
Key	Employees are offered an internal, anonymous method to report ethical violations.
Controls:	



Risk:	Employees unaware of policy requirements.
Key	Ethics policies are easily accessible by employees through placement of the Policy on the front page of the agency's intranet.
Controls:	

Appendix B: RACI Matrix

Below is an illustrative example of a Responsibility Assignment Matrix (RACI) matrix created for illustrative purposes and not current or recommended assignments.

Responsible: Completes tasks **Accountable:** Ultimately Answerable **Consulted:** Opinion Sought **Informed:** Kept up-to-date

Area	Task	General Counsel and Chief Compliance Officer	Director of HR	Deputy Executive Director	Investment Compliance Officer	Chief Investment Officer	Director of Procurement	Director of Internal Audit
Governance	Ethics Policy (Development/Review)	R	R		C	R	R	
	Ethics Training (Program)	A		I	C	I		
	Ethics Program Reporting							
	Ethics Related Statements/Agreement	C			A, R	I	A, R	I
	Ethics Training—Attendance compliance		A, R			A, R		
Compliance	Covered Persons Annual Affirmations				R	A		
	Covered Persons Conflict of Interest Determinations				R	A		
	RFP Conflict of Interest Determinations						A, R	
	Gift Compliance Determinations			A, R	I	A, R		
	Restricted Persons Pre-trade approvals				R	A		
	RFP NDAs						A, R	
Investigations	Reporting Mechanisms							
	Receipt/Triage*	R	A	R				C
	Ethics Violation Investigations	C	A	C				C

*Policy instructs employees to report to their supervisor first

Appendix C: State Statutes & Guidance

Public Retirement Systems

Texas Government Code 801 - State Pension Review Board

Texas Government Code 802 - Administrative Requirements

Texas Government Code 815 - Administration

General Government

Texas Government Code 2261 - State Contracting Standards and Oversight

Texas Government Code 2262 - Statewide Contract Management

Texas Government Code 2263 - Ethics and Disclosure

Open Government - Ethics

Texas Government Code 572 - Personal Financial Disclosure, Standards of Conduct, and Conflict of Interest

Texas Ethics Advisory Opinion #61

Texas Administrative Code 63.19

Board of Trustees - Standards of Conduct for Financial Advisors and Service Providers

Texas Penal Code

Chapter 36 - Bribery and Corrupt Influence

Chapter 39 - Abuse of Office

Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework of Internal Control

ERS Style Guide

Association of Certified Fraud Examiners

Institute of Internal Auditors

Appendix D: Ethics Policy Framework

Below is a model policy framework developed based on the Texas Statutes and ERS program and is presented here for illustrative purposes.

Goal	Objectives	Ethics Standards	Controls - Compliance Requirements -
Maintain Public Trust	Make decisions in the best interest of ERS	Standards of Conduct	Training
	Avoid situations that could or be perceived as impacting decisions for ERS	<u>Conflict of Interest</u> <ul style="list-style-type: none"> • Gifts, favors, services • Outside employment/relationships • Personal, financial interest in ERS investments/contracts • Bribes • Honoraria 	<u>Disclosures</u> <ul style="list-style-type: none"> • Financial statements (Board/ Executive Director) • Outside employment/relationships (Fiduciary) • Personal transactions (Fiduciary) • Gifts received • Conflict of interest (Procurement)
	Act with integrity, competence and dignity	<u>Abuse of Authority</u> <ul style="list-style-type: none"> • Misuse of state resources • Misuse of confidential information • Nepotism 	<u>Reporting Mechanisms</u> <ul style="list-style-type: none"> • Email submissions
			<u>Enforcement</u> <ul style="list-style-type: none"> • Investigations • Whistleblower protections • Reporting to regulatory/law