



## Audit Committee Meeting

February 22, 2017



Presented for Review and Approval

May 17, 2017

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**AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS**

**February 22, 2017  
ERS Board Room  
ERS Building – 200 E. 18<sup>th</sup> Street  
Austin, Texas 78701**

**TRUSTEES PRESENT**

I. Craig Hester, Chair  
Doug Danzeiser, Vice-Chair  
Ilesa Daniels, Member  
Cydney Donnell, Member  
Jeanie Wyatt, Member

**TRUSTEE NOT PRESENT**

Brian Ragland, Member (Excused by the Board)

**ERS STAFF PRESENT**

Porter Wilson, Executive Director  
Catherine Terrell, Deputy Executive Director  
Paula A. Jones, Deputy Executive Director and General Counsel  
Shack Nail, Director of Governmental Relations,  
Tony Chavez, Internal Auditor  
Robin Hardaway, Director of Customer Benefits  
Machelle Pharr, Chief Financial Officer  
DeeDee Sterns, Director of Human Resources  
Gabrielle Stokes, Director of Office of Procurement & Contract Oversight  
Tom Tull, Chief Investment Officer  
Chuck Turner, Director of Information Systems  
Carlos Chujoy, Investments  
Kelley Davenport, Executive Office  
Christi Davis, Customer Benefits  
Liz Geise, Benefits Communications  
Beth Gilbert, Internal Audit  
Jennifer Jones, Executive Office  
Sharmila Kassam, Deputy Chief Investment Officer  
Panayiotis Lambropoulos, Investments  
Greg Magness, Internal Audit  
Betty Martin, Investments  
Roger Nooner, Benefits Communications  
Karen Norman, Internal Audit  
Satitpong Chantarajirawong, Investments  
Jonathan Puckett, Internal Audit  
Susie Ramirez, Executive Office  
Robert Sessa, Investments  
Leighton Shantz, Investments  
Michael Shoop, Investments  
John Streun, Investments  
Keith Yawn, Strategic Initiatives

**ALSO PRESENT**

Keith Barnes, Blue Cross Blue Shield of Texas  
Robert Burg, State Auditor's Office  
Lisa Collier, State Auditor's Office  
Kristen Doyle, Aon Hewitt

Hillary Eckford, State Auditor's Office  
Colin England, Bolton Partners  
R. Ryan Falls, Gabriel Roeder Smith & Company  
Lynn Gordon, Securian  
Bill Hamilton, Retired State Employees Association  
Emily Johnson, Sunset Commission  
Thomas Lowman, Bolton Partners  
Catherine Melvin, Texas Department of Public Safety  
Joe Newton, Gabriel Roeder Smith & Company  
David Rose, Aon Hewitt Global Real Estate Research Team  
Kris Seets, Bolton Partners  
Steve Voss, Aon Hewitt

### **Meeting of the ERS Board of Trustees Audit Committee**

Mr. Craig Hester, Chairman of the Board of Trustees of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order and read the following statement:

“A public notice of the Board of Trustees meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 12:08 p.m. on Monday, February 13, 2017 as required by Chapter 551, Texas Government Code, referred to as “The Open Meetings Law.”

The Board of Trustees convened as a committee of the whole at 8:00 a.m. to consider Audit Committee agenda items. Mr. Hester noted the Audit Committee chair, Mr. Brian Ragland, was testifying before the legislature. Due to Mr. Ragland's excused absence, Mr. Hester chaired the Audit Committee Meeting.

#### **I. REVIEW AND APPROVAL OF THE MINUTES TO THE DECEMBER 2, 2016 ERS AUDIT COMMITTEE MEETING**

Mr. Craig Hester opened the floor for a motion on the approval of the minutes from the Audit Committee Meeting held December 2, 2016.

**MOTION** made by Ms. Cydney Donnell, seconded by Ms. Jeanie Wyatt, and voted unanimously by the present members of the Audit Committee to approve the minutes from the Audit Committee Meeting held on December 2, 2016.

#### **II. PRESENTATION, DISCUSSION AND CONSIDERATION OF AUDIT COMMITTEE AGENDA ITEMS:**

##### **a. External Audit Reports**

Mr. Tony Chavez, Director of Internal Audit, introduced Ms. Hillary Eckford, State Auditor's Office (SAO) Audit Manager, Robert Burg, SAO Project Manager, and Lisa Collier, SAO first assistant state auditor. Three deliverables (reports), the *Independent Auditor's Report* (Exhibit A), the *Report on Internal Controls* (Exhibit A) and the *Legislative Audit Committee Report* were part of SAO's review of ERS Consolidated Annual Financial Report (CAFR). The *Independent Auditor's Report* resulted in an unqualified opinion. The Report on Internal Controls resulted in one significant deficiency related to the active employee census data. The SAO recommended ERS strengthen controls to ensure the accuracy of active employees' census data reported to the System's actuaries. The Legislative Audit Committee Report is a report submitted to the Texas Legislative audit committee summary worked performed.

The SAO also conducted an audit of the Pension Schedules as of August 31, 2016 (Exhibit C). The reports are published on the ERS public website for state agency access.

Mr. Burg clarified that the alternative private equity, private fixed income, private infrastructure, and a few other strategic investment valuation estimates were reviewed to ensure they were materially correct. The SAO also affirmed there were adequate controls to ensure the valuations are materially correct and comply with accounting standards.

Mr. Hester asked what changes had been made to strengthen the correct identification of active members through census data finding. Ms. Machel Pharr, ERS Chief Financial Officer, explained ERS refined the process to ensure the extract of the census data is correct. Mr. Porter Wilson, Executive Director, affirmed ERS committed new resources to ensure the accuracy of this data.

**MOTION** made by Ms. Cydney Donnell, seconded by Mr. Doug Danzeiser, and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas to accept the financial audit reports as prepared by the State Auditor's Office and presented in this agenda item.

Mr. Chavez introduced Jennifer Jones, ERS Executive Office, and Colin England, Senior Consulting Actuary, Thomas Lowman, Vice President/Chief Actuary, and Kris Seets, Actuary. Bolton Partners who presented the level two actuarial audit (Exhibit D) of Gabriel Roeder Smith & Company's 2016 valuations of ERS. Overall Bolton Partners determined that the stated methods and assumptions were properly employed in determining the cost of the plan. The actual matching was within 2% of accrued liability and 5% of normal cost which are considered acceptable matches. These results are significantly better than normal. There were recommendations for future methodology.

Mr. Hester asked how ERS compares to similar institutions. Bolton replied that ERS compares favorably. In reviewing the experience study and assumptions, there are changes in the environment for investment returns, inflation assumption and the mortality assumptions. These changes need to be taken into consideration. Funding methods were reviewed. Ms. Jones reminded the Board the 31-year amortization period is standard and dictated by statute. The experience study will result in reviews of current methods. The Board participated in a discussion of amortization periods and future numbers of employees versus retirees. Bolton Partners will share a CCA "white paper" on this subject. This is for information purposes only.

b. Internal Audit Reports

- Investment Governance Review – FY2017 audit plan

Mr. Chavez introduced Ms. Karen Norman, Internal Audit, and Mr. Jonathan Puckett, Internal Audit. Mr. Chavez explained the investment governance review was conducted under consulting engagement standards. The objective was to determine if investment objectives' policies and processes were aligned with Board expectations. Observations were:

- Delegation of authority follows best practices – a governing body should be able to rely on expertise and advice of appropriately selected and un-conflicted consultants and staff.
- Key investment governance processes should be formalized to ensure consistency and proper execution
- Investment reports should be improved to allow for better performance oversight and accountability
- Investment governance practices should be better communicated and structured to improve transparency

The Board affirmed agreement with current investment delegation parameters. To ensure transparency and understanding of ERS' governance over investment practices and activities some opportunities were identified:

- 1) Spotlight ERS' governance structure including roles and responsibilities,
- 2) Establish a formal governance policy statement,
- 3) Develop separate governance documents to communicate and delineate governance activities,
- 4) Work with key internal and external stakeholders to identify relevant information and processes that would assist in monitoring investment activity,
- 5) Include roles and responsibilities in the delegation of authority section of the Investment Policy and
- 6) Include a summary of investment parameters in the Investment Policy rather than the addendums.

The Board, Mr. Wilson and Ms. Paula Jones, General Counsel, discussed common best practices and the value and need for an independent, dedicated investment compliance officer.

- Investment Compliance, Agreed-upon Procedures

Mr. Chavez introduced Ms. Beth Gilbert, Senior Internal Auditor, and Mr. Jonathan Puckett, Internal Auditor. Ms. Gilbert explained three employees self-reported executing trades that were not pre-approved before execution. All of the exceptions would have been approved had the process been followed. These were atypical situations. Mr. Puckett reported that there were no reportable issues related to the securities lending program.

- Audit recommendations status

Ms. Gilbert highlighted the procurement audit. The Office of Procurement and Contract Oversight (OPCO) partially implemented all SB20 contracting legislation and recommendations. They are in the process of procuring an electronic tracking system which will streamline and simplify the process. Ms. Gabrielle Stokes, Director of OPCO, reviewed the implementation of completed compliance measures.

c. Internal Audit Administrative Items – Review of Internal Audit Charter

Ms. Gilbert provided an update on the review of the Internal Audit Charter. New standards dictated the inclusion of the core principles for professional practice in the charter. ERS Internal Audit has adhered to these principles in practice and now the core principles are a part of the professional standards.

**MOTION** made by Ms. Cydney Donnell, seconded by Mr. Jeanie Wyatt, and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas to approve the Internal Audit Charter as revised and recommended by the Internal Audit Staff.

Mr. Chavez then introduced Internal Audit's new auditor, Mr. Greg Magness.

III. **ADJOURNMENT OF THE ERS BOARD OF TRUSTEES AUDIT COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES** –The Board of Trustees went into temporary recess.