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# ERS

EMPLOYEES  RETIREMENT  
SYSTEM OF TEXAS

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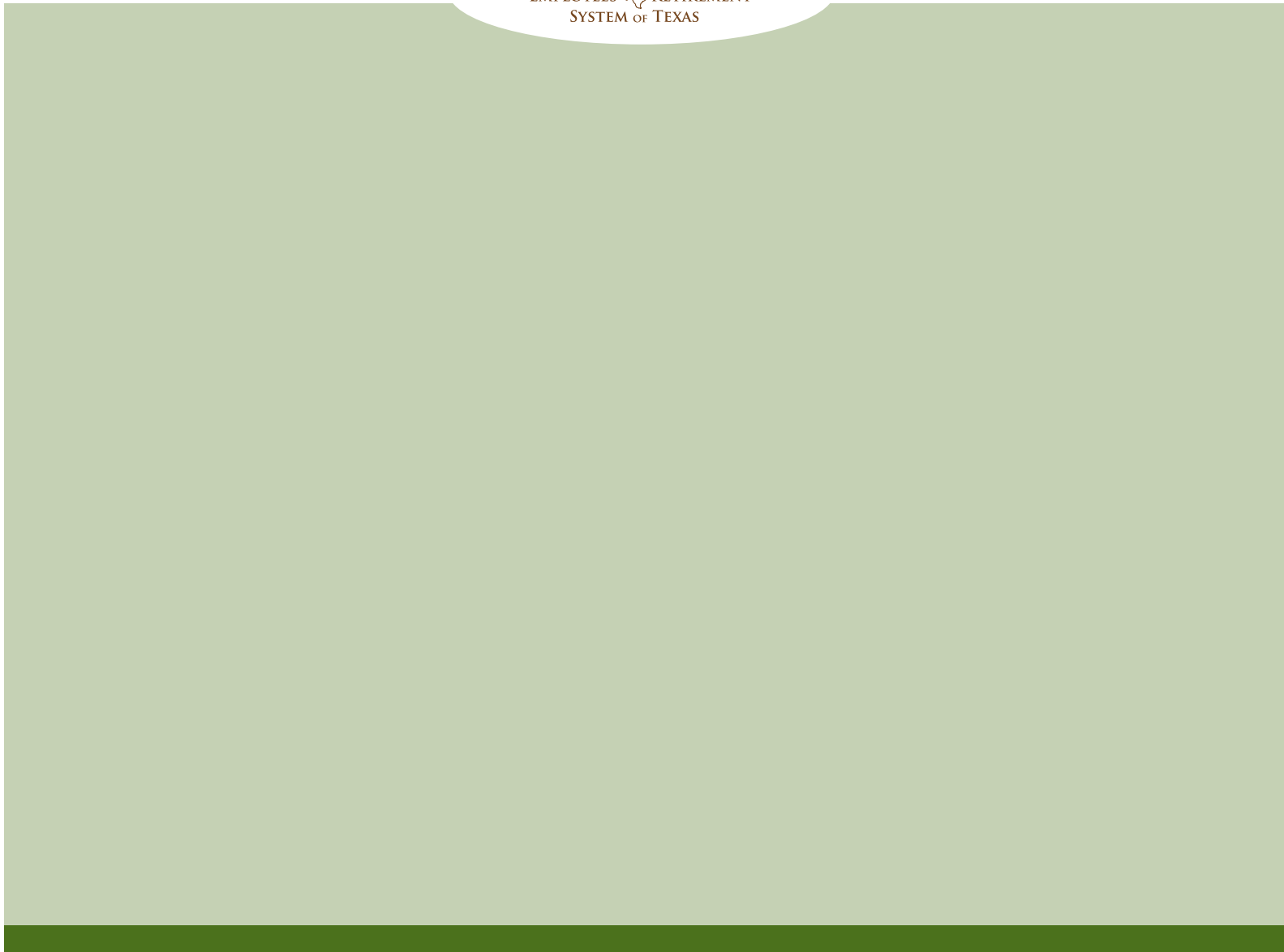


TABLE OF CONTENTS

I. Review and Approval of the Minutes to the February 24, 2015 ERS Audit Committee Meeting.....2

II. Presentation, Discussion and Consideration of Internal Audit Reports.....2

III. Adjournment of the Audit Committee – Following adjournment of the Audit Committee, the Board of Trustees will take up the remaining agenda items.....3

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

**May 19, 2015  
ERS Board Room  
ERS Building – 200 E. 18<sup>th</sup> Street  
Austin, Texas 78701**

**TRUSTEES PRESENT**

Brian Ragland, Chair  
Frederick E. Rowe, Jr., Vice-Chair  
Doug Danzeiser, Member  
Cydney Donnell, Member  
Yolanda Griego, Member  
I. Craig Hester, Member

**ERS STAFF PRESENT**

Ann S. Bishop, Executive Director  
Porter Wilson, Executive Director Designate  
Larry Zeplin, Chief Operating Officer  
Paula A. Jones, General Counsel and Chief Compliance Officer  
Tony Chavez, Internal Auditor  
Robert Kukla, Director of Benefit Contracts  
Shack Nail, Deputy Director of Governmental Affairs  
Tom Tull, Chief Investment Officer  
Charles Turner, Chief Information Officer  
Mike Wheeler, Chief Financial Officer  
Nora Alvarado, Benefit Contracts  
Kelley Davenport, Executive Office  
Beth Gilbert, Internal Audit  
Neil Henze, Investments  
Megan Hunter, Benefit Contracts  
Sharmila Kassam, Investments  
Betty Martin, Investments  
Patricia Maugham, Executive Office  
Michelle Moore, Benefit Contracts  
Jonathan Puckett, Internal Audit  
Angelica Torres, Benefit Contracts  
MaryJane Wardlow, Governmental Affairs

**ALSO PRESENT**

Nick Arnold, Humana  
Tiffany Calderon, Humana  
Ilesa Daniels, self  
Phil Dial, Rudd & Wisdom, Inc.  
Seth Hutchinson, Texas State Employees Union

Mr. Brian Ragland, Chairman of the Board of Trustees of the Employees Retirement System of Texas (ERS), 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 10:21 a.m. on Thursday, May 7, 2015 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 8:30 a.m. to consider Audit Committee agenda items.

**I. REVIEW AND APPROVAL OF THE MINUTES TO THE FEBRUARY 24, 2015 ERS AUDIT COMMITTEE MEETING**

Audit Committee Chair, Craig Hester opened the floor for a motion on the approval of the minutes from the Audit Committee Meeting held on February 24, 2015.

**MOTION** made by Ms. Cydney Donnell, seconded by Mr. Brian Ragland, and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas to approve the minutes held on February 24, 2015.

**II. PRESENTATION, DISCUSSION AND CONSIDERATION OF INTERNAL AUDIT REPORTS**

Mr. Tony Chavez, ERS' Director of Internal Audit, introduced Mr. Jonathan Puckett, Internal Auditor to present on the Public Equity Portfolio Trading audit. Mr. Puckett thanked the Investment team for their flexibility during the audit and quick turnaround to all of Internal Audit's requests.

Mr. Puckett reported the direction for the strategic alignment of this audit was supporting retirement security and the principle was to administer and manage trust assets for a premier investment program, keeping with fiduciary responsibility. The overall rating was satisfactory, which means the internal control environment provides reasonable assurance that most key goals and objectives will be met despite significant control gap corrections and opportunities for improvement. Mr. Puckett reported the objective of the audit was to assess if trades in public equity securities are efficiently executed and settled in accordance with ERS's investment strategy. The scope of the audit covered fiscal year 2014 public equity trade orders that were executed by the ERS trading team. Fiscal years 2013 and 2014 trade performance data was also used for analytical purposes, and the audit procedures only covered the portion of the trading process that occurs after a trade is sent to the trader's desk.

The audit had two scope areas, trade execution and trade performance. Trades were executed in accordance with the portfolio manager's intent and were accurately settled in a timely manner. The rating for this scope area was satisfactory.

Trade performance scope area covered defined methodology for determining and measuring trade performance. Is trade performance aligned with ERS' strategic direction and risk exposure; and is the trade performance data accurate and complete? Results showed no formal evaluation of trade performance measures to ensure alignment with ERS's investment objectives and control activities are not performed for certain trade processes. The rating for trade performance scope area is needs improvement. Mr. Puckett proceeded to give the board some background information on what the traders do and what value they add to the Investment division. He then reported on the detail results on the first observation of trade performance measures to ensure alignment with ERS's investment objections that there was no formal periodic evaluation. There was no formal basis or criteria for determining performance calculation metrics and targets. This includes the volume weighted average price (VWAP) and arrival price metrics as well as the calculation of commission rates that are reported to the board which use certain metrics to measure the performance of the commission rates. Mr. Puckett stated that some of the best practices and guidance used comes from the Committee of Sponsoring Organizations (COSO) and found that for performance metrics to be meaningful, they should be aligned with significant sources of value creation.

Adjustments benefitting performance metrics were not formally reviewed to confirm continued necessity which is related to a spread adjustment that's been employed since fiscal year 2010 for the VWAP metric. It was put in place to compensate for the volatility associated with trades that have large spreads. Mr. Puckett stated that the COSO guidance states performance measures should be reviewed periodically for ongoing adequacy in relation to incentives and rewards.

All trading team responsibilities were not included in performance measure evaluation criteria. Some trade orders are excluded from trade performance data because sometimes portfolio managers may give special instructions to traders that don't really allow them flexibility in trading the way they want to trade so they are excluded.

The ERS trading team is responsible for negotiating commission rates with brokers to obtain the best value for the services provided. Mr. Puckett reported this is not included as part of their trade performance calculation and found that COSO guidance recommends management should identify and align performance metrics with the significant sources of value creation.

Mr. Hester asked Mr. Puckett to elaborate more on what types of trades are excluded, Mr. Puckett responded by stating about 15% of the trades were excluded because of switching metrics. A portfolio is assigned a metric, either VWAP or arrival price and if the portfolio manager instructs a trader to trade as arrival price, but the portfolio is VWAP, then it is excluded. Mr. Neil Henze, ERS' head trader in the Investments division, stated trades are excluded whenever the trading desk does not have discretion over the trade, and the specific instructions given may impact the trade.

Ms. Sharmilla Kassam, Deputy Chief Investment Officer stated that the system limitations of Bloomberg, ERS benchmarking portfolios rather than individual trades, impacted the ability to track performance. ERS has been working with Bloomberg on system enhancements which are expected to be completed by the end of the fiscal year that will allow ERS to benchmark each trade which will significantly reduce the amount of exclusions because each trade will have an assigned benchmark. Mr. Hester stated this is a difficult area to measure. Staff are using industry standards. Ms. Donnell stated there is not a perfect science on how to judge trades.

Mr. Rowe asked Mr. Henze to clarify internally managed equity funds, Mr. Henze responded by saying they talk to the analyst to find out what their instructions are on the order, and then it is a process of a combination of looking to which broker provides the best execution or liquidity. Mr. Rowe wanted to know if ERS had joined any other groups. Mr. Hester wanted to know if the instructions are communicated electronically. Mr. Puckett reported control activities were not performed for certain trade performance processes. There is not a process in place to retain the special instructions, and there is no supervisory review to make sure that the trades are being excluded properly.

Mr. Puckett informed the board there were discrepancies between what was presented to the board in the February 2014 meeting and the source data for commission rates. Commission rates presented were understated; however, the source data showed the commission rates outperformed the benchmarks chosen by the trading team.

Mr. Chavez presented the quarterly investment compliance procedures. There were no questions or further discussion, and no action was required of this agenda item.

Ms. Donnell thanked Mr. Chavez and the entire Internal Audit team. Ms. Donnell noted the quality level of the audits is much improved. The audits are more constructive, meaningful, add value and are a remarkable improvement from previous audits. Mr. Hester concurred with Ms. Donnell's observations.

**III. ADJOURNMENT OF THE AUDIT COMMITTEE – FOLLOWING ADJOURNMENT OF THE AUDIT COMMITTEE, THE BOARD OF TRUSTEES WILL TAKE UP THE REMAINING AGENDA ITEMS**