



## Audit Committee Meeting

August 29, 2018



Presented for Review and Approval

December 11, 2018

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AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS  
August 29, 2018  
ERS Board Room  
ERS Building – 200 E. 18th Street  
Austin, Texas 78701

**TRUSTEES PRESENT**

Catherine Melvin, Audit Chair  
Doug Danzeiser, Board Chair  
Cydney Donnell, Board Vice-Chair  
Ilesa Daniels, Member  
I. Craig Hester, Member  
Jeanie Wyatt, Member (Via Video Conference)

**ERS STAFF 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  
Robin Hardaway, Director of Customer Benefits  
Sharmila Kassam, Deputy Chief Investment Officer  
Diana Kongevick, Director of Group Benefits  
Machelle Pharr, Chief Financial Officer  
Gabrielle Schreiber, Director of Procurement and Contract Oversight  
Chineque “DeeDee” Sterns, Director of Human Resources  
Chuck Turner, Chief Information Officer  
Keith Yawn, Director of Strategic Initiatives  
Kelley Davenport, Executive Office  
Christi Davis, Customer Benefits  
Beth Gilbert, Internal Audit  
Aaron Ismail, Investment Compliance  
Nancy Lippa, Office of General Counsel  
Betty Martin, Investments  
Karen Norman, Internal Audit  
Aris Oglesby, Investments  
Susie Ramirez, Executive Office  
Robert Sessa, Investments  
Tommy Williams, Information Systems

**ALSO PRESENT**

Bill Hamilton, Retired State Employees Association (RSEA)  
Michael McCormick, Aon Hewitt  
Brian Thomas, Weaver

## 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 8:02 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 at 8:41 a.m. on Monday, August 20, 2018, as is 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 May 23, 2018 ERS Audit Committee Meeting (ACTION)

**Move** that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes for its meeting held on May 23, 2018.

**Motion** by Cydney Donnell, second by Ilesa Daniels.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

### 3. AUDIT ITEMS

#### 3.1 Review of Internal Audit Reports

Mr. Tony Chavez, Director of Internal Audit, introduced Beth Gilbert, Internal Auditor, to present the status of audit recommendations. Internal Audit staff presents the status of management action plans and their implementation status levels twice a year. The status of a recommendation can be designated as one of three categories -- implemented, partially implemented, or no action taken with management accepting the risk identified in the audit report. The owner of the management action plan initially provides their assessment of the status and it is then confirmed by Internal Audit through review of supporting documentation.

Internal Audit reviewed action plans for two engagements this period: Revenue Processing and HealthSelect Claim Denials. Both were determined to be in the "partially implemented" stage.

The Finance Division owns the action plan for Revenue Processing. The plan was for ERS to continue coordination with other state agencies to increase efficiencies. Ms. Gilbert reported that in June 2018, 82% of state agency contributions and employee payroll deductions for retirement and insurance were now direct deposited. Automated reconciliation of the direct deposit receipts between the treasury and ERS PeopleSoft is in production and monitored by ERS financial support systems. This is a vast improvement over the previous paper warrant process that had been in place for many years. ERS initiated the change to electronic transfers and worked closely with the State Comptroller of Public Account's (CPA) Office as they made changes to their system to allow for the new process.

A second action plan related to files containing multiple pay periods. The files contained incorrect information. The cause was identified as errors emanating from processes associated with the new Centralized Accounting and Payroll/Personnel System for Texas (CAPPS). To correct future errors, ERS is working with the agencies and the CPA to fix the file exchange errors. Upon successful testing of the CAPPS Central agency files, the CPA will provide revised file formats for CAPPS HUB agencies. ERS will coordinate with these agencies to schedule testing and implementation. To correct data previously provided, ERS will begin analyzing the incorrect data previously sent by the CPA for state agencies on

the Uniform Statewide Payroll/Personnel System (USPS) or CAPPs Central. ERS will reach out to the affected agencies after the correct approach is determined to obtain information necessary to make the corrections.

There were no further discussion or questions and no action was taken on this agenda item.

3.2 Review of Internal Audit Administrative Items: Internal Audit Assessment and Proposed FY 2019 Annual Audit Plan (ACTION)

Mr. Chavez presented an overview of the Internal Audit assessment and proposed fiscal year 2019 audit plan. Internal Audit identifies, measures and prioritizes risks to determine audit engagements for the proposed audit plan.

Mr. Chavez noted that the total number of audit engagements proposed is less this fiscal year than prior years because each audit is requiring additional budget hours, and the need to have some contingency hours available for the legislative session and other operational needs. Mr. Chavez noted that the number of contingency audits has increased, which allows Internal Audit staff to be more adaptable throughout the fiscal year. Mr. Chavez highlighted significant changes to this year's risk criteria including changes to investment strategic risk criteria weight to reflect updated asset allocations and changes to information technology criteria weight in the information technology audit universe based on results of audit observations.

In addition to the overall risk rating of individual audit units, the following factors had a significant influence: industry trends, engagements suggested by leading practices, division management input, legislative interest, and time since last review. Mr. Chavez explained to the Board that once audit risks have been assigned, discussions will be held with division management and the Executive Office to narrow the number of potential audits to a shortlist for Board input. Based on input from the board, staff then develops the final proposed plan.

Mr. Chavez reported that there are a couple of carryovers from the fiscal year 2018 audit plan including HealthSelect Contract Administration, Investment Management Fees and Infrastructure (Investments). The investment management fees and infrastructure engagements are in the reporting process now and should be completed by the end of September.

Mr. Chavez highlighted the proposed audit plan for fiscal year 2019. The plan includes an audit of HealthSelect Financial Management. In response to a question from Mr. Danzeiser, Mr. Chavez noted that due to the size of this particular contract, staff decided to separate the financial and performance components for auditing purposes.

Ms. Melvin thanked the audit team for their diligence in preparing the audit plan.

There being no further discussion or questions, Ms. Melvin opened the floor for a motion.

**Move** that the Board of Trustees for the Employment Retirement System of Texas approve and adopt the proposed Fiscal Year 2019 ERS' Internal Audit Plan as listed in Exhibit A of the agenda.

Motion by Cydney Donnell, second by Doug Danzeiser.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

3.3 Review of Internal Audit Administrative Items: Annual Internal Audit Independence Assessment

Mr. Chavez informed the Board that the ERS Audit Charter states that the Internal Audit director will report annually to the Board. In 2016, the last peer review report recommended that ERS formally document and report on an assessment of independence. Mr. Chavez noted that government and internal audit standards were utilized to assist in performing this assessment. Mr. Chavez reported that audit independence is assessed by individual, organization and non-audit services performed. In addition, audit

staff identifies any potential threats to independence and evaluates the significance of those threats, both individually, and as a function, and then applies safeguards as necessary to eliminate the threats or reduce them to an acceptable level.

Mr. Chavez confirmed individual auditor independence, noting that staff is free from impairments to independence. In regards to non-audit services, safeguards are in place to prevent these services from impacting independence.

Mr. Chavez then announced and acknowledged that this would be Beth Gilbert's last Audit Committee meeting as she is officially retiring. Ms. Gilbert started at ERS in April of 2014 and Mr. Chavez noted how grateful he is for all of her assistance throughout the years.

There were no further discussion or questions and no action was taken on this agenda item.

## **4. INVESTMENT COMPLIANCE**

### **4.1 Review of Investment Compliance**

Mr. Aaron Ismail, Investment Compliance Officer, provided a status update on the recently established ERS investment compliance office. Mr. Ismail reported that the ERS Investment Compliance Office's mission is to define and oversee a compliance program that prevents, detects, and addresses issues of non-compliance; helps ERS meet its fiduciary, regulatory, and contractual obligations; align policies and procedures with high ethical conduct; and effectively educates, trains, and communicates the program throughout the organization and to the board. These are not necessarily new goals for the program. Mr. Ismail also informed the board that his role is to help define these goals on an ongoing basis and then annually make sure that they stay in line and that staff is measuring them effectively.

Mr. Ismail described the three lines of defense model for risk governance and stated that the investment staff and portfolio managers are a key part of that model. The goal is to engage with risk owners to make sure they are comfortable recognizing compliance issues.

Some of the key elements to implement an effective compliance program include ensuring its independence, creating a "Culture of Compliance" which includes making sure everyone is aware of the compliance obligations, to develop procedures to effectively monitor, test and report compliance risks, and lastly, to be proactive, and not reactive in addressing compliance issues.

Mr. Ismail said that he reports to the Director of Internal Audit. Mr. Ismail noted that he is not part of the incentive compensation plan.

Mr. Ismail stated that staff are proposing a change to the structure of the compliance reporting and communication. The compliance reports will be provided to the board on a quarterly basis. The annual compliance presented to the board in March 2019 will include an annual compliance review and report, a discussion of compliance risks and material issues, and an outline of a compliance program roadmap for the next period.

The compliance report has been reformatted. It will still include reviews of personal trading, securities lending, portfolio compliance and proxy voting. It may also include internal investment committee approvals during the period, the status of investments that may be under review, scrutinized investments and other elements of the compliance program as it evolves.

Mr. Ismail presented recent accomplishments and activities:

- Compliance monitoring has fully transitioned from internal audit to investment compliance,
- reviewing and commenting on the current investment policies and procedures and also the update of the investment policy statement,
- Improving the My Compliance Office "MCO" system to receive information electronically in order to streamline review processes,

- collaborating with legal and investment operations to implement new procedures related to investments in prohibited countries,
- developing a comprehensive annual compliance report for the Board and the Executive Director,
- creating a compliance checklist to use in asset class investment committee decision making meetings and
- evaluating additional functionality of the MCO system to see if it can capture all employee compliance reporting.

Mr. Ismail reported that his long-term goals for the program include consolidating current ERS compliance and ethics policies and procedures, continuing to develop compliance monitoring and testing frameworks across ERS, becoming a primary resource for compliance-related issues, and participating in periodic training for ERS staff and the board. He stated that he'd like to develop a compliance risk matrix, which essentially is a chart that demonstrates the compliance risk based on the likelihood of it occurring and the severity or the impact of it.

Mr. Hester asked about the process for approving personal trades. Mr. Ismail replied that the current process is Mr. Tull or Ms. Kassam approves trades of investment staff, although Mr. Ismail approves all of Mr. Tull's personal trades. Mr. Ismail is copied on all trades and is the lead on any staff have personal trading issues.

Ms. Wyatt commented that she thinks it is great that Mr. Ismail is involved in the steering committee for the new rewrite in the investment policy statement and thinks that his role in reporting to Tony really strengthens the investment compliance section for ERS. Ms. Wyatt applauds the work of Mr. Ismail and this development. Ms. Melvin also agreed with Ms. Wyatt's comment and stated that she thinks Mr. Chavez' role and Mr. Ismail's function reporting to the Director of Internal Audit is very important to make this an effective compliance function.

There were no further discussion or questions and no action was taken on this agenda item.

## **5. EXECUTIVE SESSION**

5.1 Executive Session – In accordance with Section 551.089, Texas Government Code, the Audit Committee of the Board of Trustees, a Committee of the whole of the Board will meet in executive session to discuss: (1) security assessments or deployments relating to information resources technology; (2) network security information as described by Section 2059.055(b); or (3) the deployment, or specific occasions for implementation, of security personnel, critical infrastructure, or security devices. Thereafter, the Board may consider appropriate action in open session.

Ms. Melvin stated that it is 8:40 a.m., on August 29, 2018. The Board of Trustees will meet in executive session in accordance with Section 551.089, Texas Government Code, the Audit Committee of the Board of Trustees, a committee of the whole of the Board will meet in executive session to discuss: (1) security assessments or deployments relating to information resources technology; (2) network security information as described by Section 2059.055(b); or (3) the deployment, or specific occasions for implementation, of security personnel, critical infrastructure, or security devices. Thereafter, the Board may consider appropriate action in open session.

The board returned to open session and Ms. Melvin stated that it is 9:45 a.m. on August 29, 2018. No action, decision or vote was taken by the board while in executive session.

## **6. ADJOURNMENT**

6.1 Adjournment of the ERS Board of Trustees Audit Committee

The ERS Board of Trustees Audit Committee adjourned at 9:45 a.m.

6.2 Recess of the Board of Trustees. Following a temporary recess, the Board of Trustees will reconvene with the Investment Advisory Committee to take up the following Joint Board of Trustees and Investment Advisory Committee agenda items.

The ERS Board of Trustees recessed at 9:45 a.m.