

# **Audit Committee Meeting**

**March 2015**



Teacher Retirement System of Texas  
1000 Red River Street, Austin, Texas 78701-2698

**TEACHER RETIREMENT SYSTEM OF TEXAS  
BOARD OF TRUSTEES  
AND  
AUDIT COMMITTEE**

*(Mr. Moss, Chairman; Ms. Charleston; Mr. Corpus; Ms. Palmer; & Ms. Sissney, Committee Members)*

**AGENDA**

**March 26, 2015 – 2:30 p.m.  
TRS East Building, 5<sup>th</sup> Floor, Boardroom**

1. Approve minutes of November 21, 2014 Audit Committee meeting  
– Mr. Christopher Moss, Chair
2. Receive Internal Audit reports
  - A. Payables Audit – Ms. Amy Barrett and Ms. Toma Miller
  - B. Semi-annual status report on test results of Investment Controls (Private Equity) – Mr. Hugh Ohn and Mr. Nick Ballard
  - C. Quarterly Investment Testing (Agreed-Upon Procedures) – Mr. Hugh Ohn and Mr. Nick Ballard
3. Receive reports on the status of prior audit and consulting recommendations
4. Discuss or consider Internal Audit administrative reports and matters related to governance, risk management, internal control, compliance violations, fraud, regulatory reviews or investigations, new and outstanding complaints, fraud risk areas, audits for the annual internal audit plan, or auditors' ability to perform duties – Mr. Christopher Moss and Ms. Amy Barrett

NOTE: The Board of Trustees (Board) of the Teacher Retirement System of Texas will not consider or act upon any item before the Audit Committee (Committee) at this meeting of the Committee. This meeting is not a regular meeting of the Board. However, because the full Audit Committee constitutes a quorum of the Board, the meeting of the Committee is also being posted as a meeting of the Board out of an abundance of caution.

**TAB 1**



**TEACHER RETIREMENT SYSTEM OF TEXAS  
AUDIT COMMITTEE MEETING  
November 21, 2014**

The Audit Committee of the Teacher Retirement System of Texas met on Friday, November 21, 2014 in the boardroom located on the fifth floor of the TRS East Building offices at 1000 Red River Street, Austin, Texas. The following persons were present:

**TRS Board Members**

Christopher Moss, Audit Committee Chair  
Nanette Sissney, Board Vice Chair, Audit Committee Member  
Anita Smith Palmer, Audit Committee Member  
T. Karen Charleston, Audit Committee Member  
David Corpus, Audit Committee Member  
Joe Colonna, Board Member  
Todd Barth, Board Member

**TRS Staff**

Brian Guthrie, Executive Director  
Ken Welch, Deputy Director  
Amy Barrett, Chief Audit Executive  
Hugh Ohn, Director, Investment Audit Services  
Karen Morris, Director, Pension Audit Services  
Jan Engler, Audit Manager, Internal Audit  
Dinah Arce, Senior Auditor, Internal Audit  
Lih-Jen Lan, Information Technology Audit Manager, Internal Audit  
Toma Miller, Senior Auditor, Internal Audit  
Dorvin Handrick, Senior Information Technology Auditor, Internal Audit  
Nick Ballard, Senior Investment Auditor, Internal Audit  
Art Mata, Internal Audit Consultant, Internal Audit  
Britt Harris, Chief Investment Officer  
Carolina de Onís, General Counsel  
Dan Junell, Assistant General Counsel  
Clarke Howard, Assistant General Counsel  
Heather Traeger, Chief Compliance & Ethics Officer, Legal Services  
Lynn Lau, Assistant Secretary to the Board and Program Specialist, Legal Services  
Don Green, Chief Financial Officer  
Jamie Pierce, Director, General Accounting  
Cindy Haley, Team Leader, Financial Reporting, General Accounting  
Gloria Nichols, Senior Financial Accountant, General Accounting  
Ann Zigmond, Senior Financial Accountant, General Accounting  
Pat Moraw, Senior Financial Accountant, General Accounting

### **TRS Staff (cont'd)**

Scot Leith, Director, Investment and Benefit Accounting  
Tom Guerin, Manager, Benefit Counseling  
Jay LeBlanc, Director, Risk Management & Strategic Planning  
Chris Cutler, Chief Information Officer  
T.A. Miller, Deputy Information Officer  
Vic Horton, Client Services & Support, Information Technology  
Noel Sherman, Client Services & Support, Information Technology  
Dan Herron, Communications Specialist

### **Other Attendees**

Philip Mullins, Texas State Employees Union  
Steven Huff, Reinhart Boerner Van Deuren s.c.  
Angelica Ramirez, State Auditor's Office  
Michael Clayton, State Auditor's Office  
Ron Franke, Myers and Stauffer LC  
Murali Kyasa, HP  
Melinda Maczko, HP

Audit Committee Chair Christopher Moss called the meeting to order at 8:00 a.m. with a quorum of committee members present.

### **1. APPROVE MINUTES OF SEPTEMBER 19, 2014 AUDIT COMMITTEE MEETING**

On a motion by Ms. Anita Palmer, and seconded by Ms. Nanette Sissney, the proposed minutes of the September 19, 2014 Audit Committee meeting were approved as presented.

### **2. RECEIVE STATE AUDITOR'S OFFICE REPORT ON AUDIT OF TRS' COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR FISCAL YEAR 2014**

Mr. Michael Clayton, State Auditor's Office, presented the results of the audit of TRS' Comprehensive Annual Financial Report for Fiscal Year 2014. He stated that the audit determined that the financial statements as stated were materially correct and prepared in accordance with generally accepted financial standards, and an unqualified opinion was issued. One significant deficiency was identified, and it was recommended that management strengthen controls around the data intake process from employers to ensure that the information being provided to TRS is complete and accurate.

Ms. Amy Barrett stated that management agreed with the finding and indicated that staff would address TRS' response to the recommendation in agenda item 3.

### **3. RECEIVE STATUS REPORT ON ACTIVITIES REGARDING TRS EMPLOYERS**

Ms. Barrett indicated that members of Internal Audit had travelled to several locations across the state to present information at several Texas Association of School Business Officials (TASBO) meetings and one Educational Service Center regarding the planned employer audits that will begin during fiscal year 2015.

Mr. Art Mata presented an overview of the Employer Audits web page that has been created on the TRS Internet site. He stated that the purpose of the web page is to provide employers with information regarding planned employer audit activities, audit programs and self-audit tools that employers can use to assess the completeness and accuracy of the information they are reporting to TRS.

Ms. Karen Morris provided an overview of the self-audit tools currently available on the Employer Audit Web page. She stated that the self-audit tools focus on the areas of employment after retirement, pension surcharges, and TRS-Care surcharges. In addition to allowing employers to self-assess the completeness and accuracy of the information they are reporting to TRS, the self-audit tools provide excellent education and training information for reporting entities.

Ms. Dinah Arce presented information regarding the audit risk assessment process that Internal Audit is using to determine which employers will be audited during fiscal year 2015. She stated that Internal Audit anticipates completing three to four audits during this first year of testing.

Mr. Scot Leith discussed upcoming system enhancements and changes that will impact information employers report to TRS. He stated that the new reporting system will require employers to submit complete payroll data on all employees, not just those that are currently participating in TRS. The system will then use enhanced built-in validations and edit checks to identify possible inaccuracies in the information being reported. Additionally, TRS staff will receive error reports and a full range of data to allow them to better analyze and identify possible inaccuracies in the data received.

Mr. Leith stated that TRS has already begun, and will continue, to communicate planned changes to employers. Additionally, in an effort to make the transition to the new reporting system as seamless as possible, TRS will be working with various software providers that are used by the majority of employers to ensure that they are aware of any needed changes to their report layouts and the new information that will need to be provided going forward.

#### **4. RECEIVE INTERNAL AUDIT REPORT ON THE RESULTS OF THE QUARTERLY INVESTMENT TESTING**

Ms. Barrett informed the committee that no issues were identified during the quarterly investment testing. She noted that testing has been expanded to evaluate adherence with various TRS ethics policies. This quarter's ethics related testing, she said, focused on the vendor code of ethics and ensured that vendors submitted their annual disclosure statements as required. She also indicated that in the future, results of the on-going investment testing will be reported twice a year rather than quarterly.

#### **5. RECEIVE INFORMATION TECHNOLOGY RISKS AND STATUS UPDATES ON RELATED TRS INITIATIVES**

##### **A. Technology risks, what every trustee should know**

Mr. Ron Franke, Myers and Stauffer LC, gave a high-level presentation regarding information technology (IT) risks. The presentation touched briefly on risks associated with cybersecurity, privacy, data management, availability and continuity, and project and portfolio management.

Additionally, Mr. Franke identified some general questions and areas of discussion that the Board may consider when discussing information technology risks with TRS management.

## **B. Co-location, mobile device, and cloud computing projects at TRS**

Mr. Chris Cutler presented information regarding three top emerging IT risk areas at TRS. The three areas were co-location and disaster recovery, cloud computing, and mobile device security. Mr. Cutler stated that the IT department has been working with Myers and Stauffer LC to evaluate TRS's approach to mitigating these risk areas and he provided an overview of the results of the consulting project.

In regards to disaster recovery plans, Mr. Cutler stated that due to the growing number and complexity of systems needed to conduct TRS operations, the organization is establishing a co-location to be used for disaster recovery. This will be a secondary location that will contain a complete data center fully synchronized with the main data center at TRS. This will allow for a majority of information systems to be up and running within one to three hours of a disaster versus the 72 hour and limited system availability plan that TRS currently has in place.

Mr. Cutler stated that Myers and Stauffer reviewed TRS' plans for co-location and found the strategy to be sound and in alignment with similar approaches being taken by other state, federal, and private organizations. Mr. Cutler stated that Myers and Stauffer also provided some helpful recommendations regarding documentation of the decision process, review of contract terms with third party providers, and security controls that should be considered.

In regards to cloud computing, Mr. Cutler stated that the consulting project identified areas that TRS can improve upon going forward. As a result, a cloud computing committee has been established and will create a formalized process to be used when making decisions about engaging in cloud computing. The committee will look at updating policies and procedures, providing documented guidance to help determine when cloud computing is a good fit for TRS, and create a governance process to assist decision makers in their due diligence process.

Lastly, Mr. Cutler discussed mobile device security. He stated that the consulting project found that TRS' current policies and procedures address most of the generally recognized security risks associated with mobile device security. TRS is currently capable of meeting most of the user requirements to allow secure remote access and mobile device functionality for employees. TRS' focus in this area will be on continuing to strengthen policy and procedures, continue to strengthen mobile device capabilities, testing mobile device management software, and developing employee education programs to increase the awareness of what mobile device solutions are available to help meet the needs of employees.

## **6. RECEIVE REPORT ON TRS INFORMATION SECURITY FOLLOW-UP AUDIT AND INFORMATION SECURITY PROGRAM INITIATIVES**

Pursuant to sections 551.076 and 825.115(d) of the Texas Government Code, the Audit Committee adjourned into executive session on agenda items 6A and 6B to discuss confidential audit matters related to information security. The time was 9:10 a.m.

### **A. TRS Information Security Follow-Up Audit**

**B. Information Security Program Initiatives**

The meeting reconvened in open session at 9:59 a.m.

**7. RECEIVE REPORTS ON THE FISCAL YEAR 2014 INTERNAL AUDIT ANNUAL REPORT AND STATUS OF PRIOR AUDIT AND CONSULTING RECOMMENDATIONS**

**A. Fiscal Year 2014 Internal Audit Annual Report**

Ms. Barrett gave an overview of the Internal Audit Annual Report issued each year in accordance with the Texas Internal Auditing Act, with copies given to the State Auditor’s Office, Legislative Budget Board, Sunset Advisory Commission, and the Governor’s Office. This annual report is also posted to the TRS website.

**B. Status of Prior Audit and Consulting Recommendations**

Ms. Barrett stated that progress is being made on all previous recommendations.

**8. DISCUSS OR CONSIDER INTERNAL AUDIT ADMINISTRATIVE REPORTS AND MATTERS RELATED TO GOVERNANCE, RISK MANAGEMENT, INTERNAL CONTROL, COMPLIANCE VIOLATIONS, FRAUD, REGULATORY REVIEWS OR INVESTIGATIONS, HOTLINE USAGE REPORT, FRAUD RISK AREAS, AUDITS FOR THE ANNUAL INTERNAL AUDIT PLAN, OR AUDITORS' ABILITY TO PERFORM DUTIES**

Ms. Barrett briefly discussed a consulting project recently completed by students from the University of Texas at Austin and coordinated by Dinah Arce of Internal Audit. The objective of the project was for the students to evaluate the TRS Educational Assistance Policy in order to make recommendations for improvement. The students accomplished this by comparing the TRS policy to policies of other retirement systems and by conducting interviews of TRS employees who have utilized the educational assistance program. Ms. Barrett stated that the project was very successful.

The meeting adjourned at 10:02 a.m.

Approved by the Audit Committee of the Board of Trustees of the Teacher Retirement System of Texas on the 27th day of March, 2015.

Attested by:

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Christopher Moss  
Chair, Audit Committee  
Board of Trustees  
Teacher Retirement System of Texas

**TAB 2**

**TAB 2A**

**PAYABLES AUDIT**  
 March 2015  
 TRS Internal Audit Department

<b>Business Objective</b>	Ensure TRS receives goods and services as approved and invoiced prior to payment being issued. <sup>1</sup>
<b>Business Risks</b>	<ul style="list-style-type: none"> <li>Overpayment of goods and services due to fraud or errors</li> <li>Payment for goods and services that are not received</li> <li>Payment to the wrong or unauthorized vendor</li> </ul>
<b>Audit Testing Performed</b>	<ul style="list-style-type: none"> <li>Selected a sample of goods and services payments made within fiscal years 2010 - 2014 and validated that goods or services were received and described payment processes were followed</li> <li>Evaluated key management controls in the payment process:               <ul style="list-style-type: none"> <li>Three-way match between approved purchase order/contract, goods and services received, and invoice. Also, verified payment amount matched approved payment voucher</li> <li>Departmental authorization prior to payment</li> <li>Review and approval of purchase vouchers</li> <li>Segregation of duties between purchasing, payables, and receivables functions (including system access review)</li> </ul> </li> <li>Performed searches using the Secretary of State site to identify any potential conflict of interest between key staff members and vendors with whom TRS does business</li> </ul>
<b>Results</b>	<ul style="list-style-type: none"> <li>No significant issues were identified</li> <li>Management controls are operating effectively to ensure receipt of goods and services as approved and invoiced prior to being paid</li> <li>One opportunity to improve segregation of duties controls within the vendor setup and payment process exists</li> </ul>
<b>Recommended Actions</b>	<p>General Accounting management should review the current vendor setup and payment processing functions and establish segregation of duties to ensure that the same individuals do not have access to perform both functions. If this solution is not conducive to current staffing or operational needs, then sufficient compensating controls should be implemented until actual segregation of duties can be established.</p>
<b>Management Responses</b>	<p>Management agrees with the recommendation and strives to ensure vendors are set up in accordance with laws, policies, and procedures. We will review the current process and identify opportunities to strengthen controls to include appropriate segregation of duties. This could include assigning vendor set-up to an employee outside of the Accounts Payable Team. Our goal for completion of this task is May 31, 2015.</p>

Legend of Results: Red - Significant to TRS      Orange - Significant to Business Objectives  
Yellow - Other Reportable Issue      Green - Positive Finding or No Issue

<sup>1</sup> Per Section 2.38 of the State of Texas Procurement Manual issued by the Texas Comptroller of Public Accounts, advanced payments can be made if necessary and serves a proper public purpose.



March 10, 2015

Audit Committee, Board of Trustees  
Brian Guthrie, Executive Director

## EXECUTIVE SUMMARY

We have completed the audit of **Payables**, as included in the *Fiscal Year 2015 Audit Plan*. This project was a follow-up audit to the Purchasing and Contract Administration Audit reported in September 2014. The business objective related to the Accounts Payable area is to ensure TRS receives goods and services as approved and invoiced prior to payment being issued.<sup>1</sup>

Based on our audit results, we determined that management controls tested are operating effectively to ensure receipt of goods and services as approved and invoiced prior to payment being issued. We did not identify any significant issues. However, an opportunity to improve segregation of duties controls within the vendor setup and payment process was identified.

Results of our procedures are presented in more detail in the **Results and Recommendations** section (page 3). The audit objective, scope, methodology and conclusion are described in **Appendix A** (page 5).

## BACKGROUND

This audit focused primarily on processes carried out by the Accounts Payable Team within the General Accounting department.

During fiscal year 2014, TRS expended approximately \$7 million on goods and services related to materials, communications, utilities, repairs/maintenance, rentals/leases, printing and reproduction. Management procedures require each of these expenditures to follow a defined process and every invoice to be reviewed for accuracy prior to payment. An overview of the complete vendor payment process is included in **Appendix B** (page 7).

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<sup>1</sup> Per Section 2.38 of the State of Texas Procurement Manual issued by the Texas Comptroller of Public Accounts, advanced payments can be made if necessary and serves a proper public purpose.

## BUSINESS OBJECTIVES, RISKS, AND CONTROLS

For the audit of Payables, we obtained information about the following business objective, as well as the related risks and the controls management established to mitigate these risks:

<b>Business Objectives</b>	<b>Ensure TRS receives goods and services as approved and invoiced prior to payment being issued.<sup>1</sup></b>
<b>Business Risks</b>	<ul style="list-style-type: none"> <li>• Overpayment of goods and services due to fraud or errors</li> <li>• Payment for goods and services that are not received</li> <li>• Payment to the wrong or unauthorized vendor</li> </ul>
<b>Management Controls</b>	<ul style="list-style-type: none"> <li>• Purchase request forms (TRS146) follow a designated workflow that cannot be altered and requires manager approval</li> <li>• Segregation of duties between purchasing, payables, and receivables (including system access review)</li> <li>• Conduct three-way match between approved purchase order/contract, goods and services received, and payment invoice prior to payment being issued</li> <li>• Departments are required to review and approve invoices prior to payment</li> <li>• Review and approval of purchase vouchers by individuals outside of Accounts Payable, including approval of payment in the Uniform Statewide Accounting System (USAS)</li> <li>• When setting up a new vendor, the information entered into the Comptroller of Public Accounts (CPA) Texas Identification Number System (TINS) must match the Secretary of State records to be accepted as a valid vendor</li> <li>• Cashier verifies that all warrants and electronic fund transfers have a corresponding approved voucher before releasing the payment</li> </ul>
<b>Controls Tested</b>	<ul style="list-style-type: none"> <li>• Segregation of duties between purchasing, payables, and receivables functions (including system access review)</li> <li>• Three-way match between approved purchase order/contract, goods and services received, and payment invoice prior to payment being issued</li> <li>• Departments required to review and approve invoices prior to payment</li> <li>• Review and approval of purchase vouchers by individuals outside of Accounts Payable, including approval of payment in USAS</li> </ul>

# RESULTS AND RECOMMENDATIONS

## OVERALL RESULTS

Based on our audit results, we determined that management controls tested are operating effectively to ensure receipt of goods and services as approved and invoiced prior to payment being issued. We did not identify any significant issues. However, an opportunity to improve segregation of duties controls within the vendor setup and payment process was identified.

## POSITIVE RESULTS

### A. Imaged payment files are well organized and accessible

The auditor was able to examine records with very little assistance from staff. Payment information and supporting documentation was well maintained allowing for an efficient review.

### B. Accounts Payable staff members are very knowledgeable

Collectively, the Accounts Payable staff have many years of experience processing payments within the state environment. They are very knowledgeable of policies and procedures and operate in a very professional and expert manner.

## SIGNIFICANT RESULTS<sup>2</sup>

No significant issues and recommendations were identified.

## OTHER REPORTABLE RESULTS

### 1. **Improve segregation of duties within the vendor setup and payment process**

Results of our testing indicated that Accounts Payable staff often set up new vendors within the Comptroller of Public Accounts (CPA) Texas Identification Number System (TINS) as well as the vendor table within the TRS payment application. Since these individuals may set up and also initiate payments to the same vendors, this represents an inherent conflict of interest. Separation of vendor setup and payment functions is key to preventing fraudulent vendors from being established for the purpose of issuing fraudulent payments.

### **Recommendation**

General Accounting management should review the current vendor setup and payment processing functions and establish segregation of duties to ensure that the same individuals do not have access to perform both functions. If this solution is not conducive to current staffing or operational needs, then sufficient compensating controls should be implemented until actual segregation of duties can be established.

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<sup>2</sup> A significant result is defined as a control weakness that is likely to create a high risk of not meeting business objectives if not corrected.

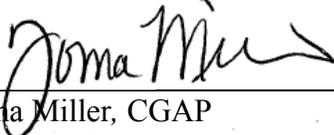
## Management Response

Management agrees with the recommendation and strives to ensure vendors are set up in accordance with laws, policies, and procedures. We will review the current process and identify opportunities to strengthen controls to include appropriate segregation of duties. This could include assigning vendor set-up to an employee outside of the Accounts Payable Team. Our goal for completion of this task is May 31, 2015.

\* \* \* \* \*

We appreciate General Accounting, Accounts Payable, and Staff Services management and staff for their cooperation, courtesy, and professionalism extended to us during this audit. We also appreciate support provided by Information Technology staff during this audit.

  
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Amy Barrett, CIA, CPA, CISA  
Chief Audit Executive

  
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Tom Miller, CGAP  
Senior Auditor

## APPENDIX A

### AUDIT OBJECTIVE, SCOPE, METHODOLOGY, AND CONCLUSION

We conducted this performance audit in accordance with generally accepted government auditing standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States and the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors, Inc.

These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our audit findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

#### AUDIT OBJECTIVE

The audit objective was to assess whether TRS received goods and services as invoiced and paid between fiscal years 2010 – 2014 and to determine whether internal controls are in place and working effectively to achieve the business objective stated below and mitigate significant risks to meeting the objective.

*Ensure TRS receives goods and services as approved and invoiced prior to payment being issued (unless an advanced payment is necessary and serves a proper public purpose per section 2.38 of the State of Texas Procurement Manual issued by the Texas Comptroller of Public Accounts.)*

#### SCOPE

The scope of the audit included goods and services paid within fiscal years 2010-2014.

#### METHODOLOGY

Our audit methodology included obtaining information on management's business objective, associated risks, key processes, and monitoring controls established by management to address identified risks. To meet the audit objectives, we specifically performed the following procedures:

- Selected a sample of goods and services payments made within fiscal years 2010-2014 and validated that goods or services were received and that the described payment processes were followed
- Evaluated the following key management controls in the payment process:
  - Segregation of duties between purchasing, payables, and receivables functions (including system access review)
  - Three-way match between approved purchase order/contract, goods and services received, and payment invoice prior to payment being issued. Also, verified that the amount of the payment issued matched the approved purchase voucher
  - Departmental authorization prior to payment
  - Review and approval of purchase vouchers by individuals outside of Accounts Payable, including approval of payment in USAS

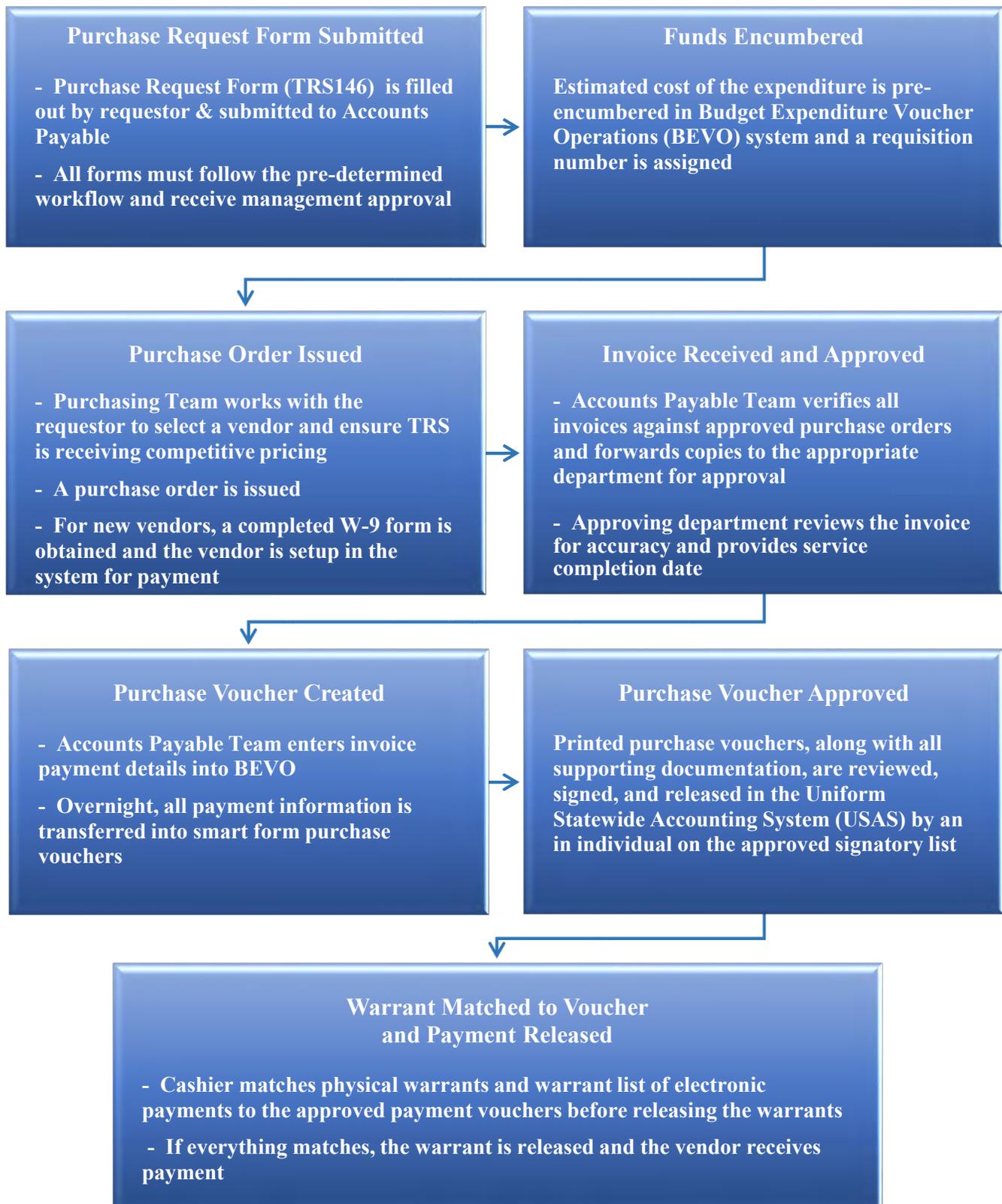
- Performed searches using the Secretary of State site to identify any potential conflict of interest between key staff members and vendors with whom TRS does business

## **CONCLUSION**

Based on our audit results, we determined that management controls tested are operating effectively to ensure receipt of goods and services as approved and invoiced prior to payment being issued. We did not identify any significant issues. However, an opportunity to improve segregation of duties controls within the vendor setup and payment process was identified.

## APPENDIX B

### VENDOR PAYMENT PROCESS



**TAB 2B**

# SEMI-ANNUAL TEST RESULTS OF INVESTMENT CONTROLS

March 11, 2015

## TRS Internal Audit Department

<b>Business Objectives</b>	<p><b>Private Equity Portfolio:</b></p> <p>Invest in private equity funds (including co-investments) to generate long-term rate of return in excess of policy benchmark and provide portfolio diversification</p>	<p><b>Investment Accounting:</b></p> <p>Ensure that private markets investments are reported at fair value in accordance with industry standards</p>
<b>Business Risks</b>	<ul style="list-style-type: none"> <li>• Investments not fitting strategy</li> <li>• Selecting managers or funds with inadequate qualifications</li> <li>• Key person risk</li> <li>• Strategy or style drift</li> <li>• Lack of transparency</li> <li>• General Partner's (GP) noncompliance with Limited Partnership Agreement (LPA)</li> <li>• Fraud or mismanagement of funds</li> </ul>	<ul style="list-style-type: none"> <li>• Portfolio values not reported at fair value</li> <li>• TRS' or GP's valuation policies not consistent with industry standards</li> <li>• No third-party assurance provided on partnership's financial statements</li> <li>• Financials not presented in accordance with U.S. or other acceptable GAAP (Generally Accepted Accounting Principles)</li> <li>• Failure to take action on deficiencies noted</li> <li>• Risks related to wire transfers to GPs</li> </ul>
<b>Management Controls</b>	<ul style="list-style-type: none"> <li>• Investment staff's initial due diligence</li> <li>• Consultant's due diligence</li> <li>• Internal Investment Committee approval</li> <li>• Provisions included in LPA</li> <li>• Investment staff's continuous monitoring</li> <li>• Semi-annual portfolio review</li> </ul>	<ul style="list-style-type: none"> <li>• Investment and Investment Accounting staff's monitoring of partnership values</li> <li>• TRS Securities Valuation Guidelines</li> <li>• Required audit of partnership financials</li> <li>• Investment Accounting staff's tracking of audited partnership financial reports</li> </ul>
<b>Controls Tested</b>	<ul style="list-style-type: none"> <li>• Investment staff's initial due diligence</li> <li>• Internal Investment Committee approval</li> <li>• Participation in the Limited Partnership Advisory Committee (LPAC) meetings</li> <li>• Semi-annual portfolio review</li> </ul>	<ul style="list-style-type: none"> <li>• Investment Accounting staff's reconciliation of partnership values</li> <li>• TRS Securities Valuation Guidelines</li> <li>• Investment Accounting staff's tracking of audited partnership financial reports</li> </ul>
<b>Results</b>	<p>Management controls are operating effectively. However, we identified opportunities to enhance controls.</p>	<p>Most management controls are operating effectively. However, we noted two control weaknesses related to valuation guidelines and performance incentive calculations</p>
<b>Recommended Actions</b>	<ul style="list-style-type: none"> <li>• Continue efforts to increase GP's disclosure on fees and expenses as advocated by the Institutional Limited Partners Association's (ILPA) best practices</li> <li>• Clarify policies to ensure consistent documentation of Private Equity due diligence and monitoring activities</li> </ul>	<ul style="list-style-type: none"> <li>• TRS Securities Valuation Guidelines are not current and should be updated</li> <li>• Management is developing formal procedures to ensure the accuracy of performance incentive pay; therefore, we have no additional recommendations</li> </ul>
<b>Management Responses</b>	<p>Management agrees. Management will:</p> <ul style="list-style-type: none"> <li>• Continue to emphasize ILPA best practices while implementing a new reporting system which will include fee information</li> <li>• Reiterate and clarify the due diligence documentation guidelines</li> </ul>	<p>Management agrees. Management is reviewing and updating TRS Securities Valuation Guidelines, including policy clarifications and the requirements of newly-issued fair value measurement standards</p>

Legend of Results:

**Red**  
**Yellow**

- Significant to TRS  
- Other Reportable Issue

**Orange**  
**Green**

- Significant to Business Objectives  
- Positive Finding or No Issue

## MEMORANDUM

TO: Audit Committee Members, TRS Board of Trustees  
Brian Guthrie, Executive Director

FROM: Amy Barrett, Chief Audit Executive  
Hugh Ohn, Director of Investment Audit Services

SUBJECT: **Semi-Annual Test Results of Investment Controls**

DATE: March 11, 2015

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The purpose of this memo is to report the interim results of Internal Audit's tests of Investment Management Division (IMD) controls for the first half of fiscal year 2015. The results of these tests will be combined with prior results to express the overall opinion on IMD controls at the end of the fiscal year based on the tests performed in the past three years. For the first half of fiscal year 2015, we tested controls related to the Private Equity Portfolio which is managed by the External Private Markets (EPM) group of the IMD and whose values are overseen by the Investment Accounting team reporting to the Chief Financial Officer (CFO).

### OVERVIEW

#### Characteristics of Private Equity (PE) Investments

Private equity represents an asset class consisting of equity securities and debt in operating companies that are not publicly traded on a stock exchange. Private equity investments range from initial capital in start-up enterprises to leveraged buyouts of mature corporations. Private equity investments are typically long-term commitments that may last up to 12 years or more. Although they are illiquid and perhaps riskier on a standalone basis than publicly traded investments, when employed consistently as part of a larger balanced portfolio, they can offer higher returns than traditional public equity investments. Specifically, private equity investments exhibit the following characteristics:

- Lack of transparency – Information about private equity, such as investment strategies, investment holdings, investment performance, is not publically available. Information is scarce, non-systemic, and difficult to obtain.
- Illiquidity – The private equity investments generally cannot be sold at short notice and require a long-term capital commitment.
- Potential for higher returns – Private equity investments have the potential to offer investors higher returns. Such higher returns, however, are compensating investors for a higher degree of illiquidity and less transparency surrounding these investments.
- Additional diversification – Private equity investments have different return characteristics from traditional asset classes. Their returns are less correlated with traditional equity and fixed income securities, mitigating overall portfolio risk.

**First Semi-Annual Investment Control Test Results  
March 11, 2015 Memorandum**

- Longer-term time horizon – Private equity investments are relatively illiquid, typically with lock-up investments periods, with an average life of 10 – 12 years. Long-term investors such as pension funds do not require a high level of liquidity, and therefore, can benefit from the “liquidity risk premium,” meaning that private equity investments generally provide compensation in the form of higher returns for the associated lockup of the capital.

TRS Private Equity Portfolio

According to the TRS Investment Policy Statement (IPS), the primary long-term objective of the Private Equity Portfolio is to develop a prudently diversified portfolio of investments that is expected to enhance the overall risk-return profile of the Total Fund and to reduce risk within the Private Equity Portfolio.

The IPS specifies that the current target asset allocation for the Private Equity Portfolio is 13% of the Total Fund with a minimum range of 8% and a maximum range of 18%. The performance benchmark for the Private Equity Portfolio is the Customized State Street Private Equity Index (lagged one quarter).

To meet the portfolio objectives, the Private Equity Portfolio has diversified investments in a broad cross section of the following attributes: strategy, geography, industry sectors, size of investment, and vintage year.

The TRS Private Equity Portfolio is invested primarily in limited partnership investment vehicles. The partnerships, which are managed by a General Partner (GP), acquire or create ongoing businesses or operating companies. Ultimately, the underlying companies are sold in the public market or to strategic or financial buyers, thus realizing a return on each investment.

The Private Equity team of the External Private Markets (EPM) group within the IMD manages the Private Equity Portfolio. This team, led by the Senior Managing Director of the EPM and Senior Director of Private Equity, consists of investment managers, associates, and analysts. These Private Equity team members are responsible for conducting initial due diligence (before making capital commitments to Private Equity funds) as well as performing continuous monitoring of Private Equity funds in which TRS invested. The team is also assisted by outside advisors and consultants.

As of December 31, 2014, the TRS Private Equity Portfolio (including co-investments and Emerging Managers) committed capital to 144 funds (with 78 managers) and the total amount of capital commitment was approximately \$22.9 billion. The market value of the portfolio was approximately \$15.2 billion which represents approximately 11.7% of the Total Fund. According to State Street Bank’s PureView investment performance report, one-year and three-year returns of the TRS Private Equity Portfolio (excluding Private Markets Strategic Partners’ investments) were 17.16% and 17.86%, respectively, outperforming its benchmark by 3.84 % and 4.63%, respectively.

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Accounting and Reporting of TRS Private Equity Investments

Accounting and financial reporting of the Private Equity Portfolio is performed by the custodian (i.e., State Street Bank). Accordingly, State Street Bank (SSB) is TRS' book of records for accounting and financial reporting purposes. Based on quarterly financial reports submitted by GPs as well as the records of fund transfers between GPs and TRS, SSB prepares monthly financial reports on fair values of TRS' partnership interest in the Private Equity portfolio. SSB is also responsible for measuring and reporting performance of TRS investments, including the Private Equity Portfolio.

The Investment Accounting team, reporting directly to the Chief Financial Officer outside the IMD, reviews and oversees the fair values of Private Equity investments prepared by SSB. Specifically, the team is responsible for verifying that the values of TRS' investments in Private Equity partnerships (as a limited partner) are complete and accurate according to TRS Valuation Guidelines, which is accomplished by comparing quarterly financial statements reported from GPs to SSB reports, tracking and comparing cumulative funding amounts to the total commitments, and reviewing the partnerships' audited financial statement on an annual basis.

**FINDINGS AND RECOMMENDED ACTIONS**

Overall, we determined that management controls at the IMD are operating effectively to achieve the business objective of the Private Equity Portfolio. Examples of the positive results we noted during our sample testing of Private Equity transactions included the following:

- Investment staff's initial due diligence was thorough, covering all important areas (such as key person provision and valuation policies)
- Investment staff's due diligence results supported what was recommended to the Internal Investment Committee
- All Private Equity deals were with managers in the Premier List and scrutinized prior to the approval by the Internal Investment Committee
- Semi-annual portfolio reviews were conducted to analyze manager performance, fund performance, and the underlying portfolio holdings of the fund
- Total funded amount of each fund was within the committed capital
- Monthly and quarterly reconciliations of values per General Partner records, Investment Accounting's records, and State Street Bank's records were performed for all funds
- Quarterly financial statements and annual audited reports from General Partners were tracked and updated
- For dissolved funds, final audited statements were received from General Partners and the amounts of funds returned to TRS were supported by these statements

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Although no significant issues or control deficiencies were identified, we identified the following opportunities to enhance controls related to investing and financial reporting of the Private Equity Portfolio:

**1. Continue Efforts to Increase General Partners' Transparency on Fees and Expenses**

We noted that General Partners' disclosures on management fees, incentive fees, and partnership expenses are not detailed enough to allow Limited Partners, like TRS, to fully understand them or check reasonableness of these fees or charges. The Securities and Exchange Commission (SEC), after examining financial records of many private equity partnerships, has recently announced and started criticizing private equity firms' lack of transparency with regards to their practices related to fees and expenses they charge to limited partners. After these announcements and criticisms, a few large private equity firms have returned some fees to limited partners and promised to provide greater disclosures. These recent developments are very encouraging and we hope the trend will continue to influence more private equity firms to follow suit for increased transparency.

In an effort to increase GP's disclosure practices, the TRS Private Equity team sent a request to GPs in April 2014, asking them to provide the Institutional Limited Partner Association (ILPA) Capital Call and Distribution Template (which is included in the ILPA Best Practices) along with future capital calls and distributions. However, according to Private Equity staff, the GPs' adherence rates to this request still remain low. GPs' adherence to these ILPA Best Practices would improve transparency on fees and expenses charged to TRS.

**Recommendation**

We recommend that the IMD continue its efforts to increase GPs' disclosure practices on fees and expenses by taking follow-up action to stress the importance of adhering to the ILPA's Best Practices.

**Management's Action Plan**

Management agrees with the recommendation. Management will continue to emphasize ILPA best practices. Management is also implementing a new reporting system through our eFront system schedule for June 1, 2015 rollout which will include fee information.

**2. Clarify Guidelines to Ensure Consistent Documentation of Private Equity Staff's Due Diligence and Monitoring Activities**

We were able to verify that Private Equity staff performed initial due diligence (before committing capital) as well as continuous monitoring of managers and funds afterwards. Evidence of these activities is usually saved in designated information system folders or the information technology system (i.e., Tamale). However, all of these activities were not always documented or they were not consistently saved in these locations. For example, we noted the following:

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- Meeting notes or agendas documenting Limited Partners Advisory Committee (LPAC) meeting attendance (including information on main discussions or any important decisions made) did not exist in electronic systems, in most cases. However, we were able to indirectly verify Private Equity staff's attendance through travel logs.
- Information obtained through reference checks on prospective managers were not saved in the electronic systems in most cases. Private Equity staff were concerned with saving this type of confidential information in the electronic systems or folders. Instead, team members stated that this information was kept in their handwritten notes.
- Manager due diligence information was not consistently located in electronic systems. Depending on individual staff's preference, some information was saved in designated folders while other information in Tamale.

Lack of clear guidelines for documenting initial due diligence and continuous monitoring activities, as well as investment staff's practice of keeping manager reference checks information in their personal notes, appears to have contributed to these inconsistent documentation practices. Clarifying guidelines regarding documentation of investment staff's due diligence and monitoring activities would provide consistent expectations for investment staff, and also ensure that the IMD complies with the requirements of the TRS record-keeping policies.

**Recommendation**

We recommend that the IMD clarify policies to ensure consistent documentation of investment staff's initial due diligence and subsequent monitoring activities, including information related to LPAC meeting attendance notes, manager reference calls, and proper electronic locations to save different types of records.

**Management's Action Plan**

Management agrees with the recommendation. Management will reiterate and clarify the guidelines used to document due diligence and monitoring activities by June 1, 2015.

**3. Provide Clear Guidelines for Acceptable Accounting and Valuation Standards for Private Equity Investments**

During our review of the processes related to TRS' monitoring of accounting and valuation practices of Private Equity fund partnerships, we noted the following:

- The TRS Valuation Guidelines have not been updated since its initial development in April 2010. Some sections, including sections related to the Valuation Committee and references to the Governmental Accounting Standard Board (GASB) No. 25, *Financial Reporting for Defined Benefit Pension Plans*, or the American Institute of Certified Public Accountants (AICPA) *Audit and Accounting Guide for Investment Companies*, need to be updated.
- Policies are not clear about which accounting standards are acceptable for partnerships to follow to prepare their financial statements when they do not follow the Generally Accepted Accounting Standards (GAAP) of the U.S. Investment Accounting informally determined that in addition to the U.S. GAAP or International Financial Reporting

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Standards (IFRS), the GAAP of the United Kingdom are acceptable, but its policies are not clear about the GAAP of other foreign countries.

- The Investment Accounting team tracks various information contained in annual financial statements of the Private Equity partnerships, such as submission date, name of audit firm, accounting standards followed, and any difference in net asset value between audited financial statements and capital account statement. However, this information is not regularly shared with External Private Markets staff of the IMD.

**Recommendation**

We recommend that Investment Accounting provide clear guidelines for acceptable accounting and valuation standard for Private Equity investments by: (a) updating the TRS Valuations Guidelines, (b) clarifying policies for acceptable or non-acceptable accounting standards for preparing partnership financial statements (especially for foreign partnerships), and (c) regularly (e.g., monthly or quarterly) sharing a summary of information included in the annual audited financial statements of the partnerships with IMD staff.

**Management's Action Plan**

Management agrees with the recommendation. Management is reviewing and updating the TRS Valuations Guidelines including clarifying policies, developing processes to evaluate inputs to the fair value measurement, and confirming roles and responsibilities in preparation for new GASB 72 Fair Value Measurement and Application guidelines that will become effective in FY 2016. Additionally, management will work with IMD staff to share valuation information on a regular basis. We will complete our review and have an updated policy in place by September 1, 2015.

**OTHER OBSERVATION**

**Lack of Formal Procedures for Calculating and Verifying Performance Incentive Plan Awards**

During the audit, a few instances of calculation errors and mistakes came to our attention, particularly involving the Senior Managing Director of the External Private Markets and four Private Equity staff in the analyst pool. In one instance, calculations did not properly allocate these people's time between the Private Equity profit center and the Real Asset profit center. As a result, incorrect incentive pay amounts were reported to the Legislative Budget Board and the Governor's Office, although these errors and mistakes were detected in time and corrected before making payments to plan participants.

Based upon the information provided by the Human Resources and the IMD, the Investment Accounting team is responsible for independently calculating the amounts of performance incentive awards for IMD employees in accordance with the Performance Incentive Pay Plan policy adopted by the Board of Trustees. Causes of the calculation errors and mistakes included ineffective coordination among different groups regarding personnel action, lack of formal procedures, and staff's not following established, informal procedures.

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To avoid similar calculation errors or mistakes in the future, the Executive Director put together a task force, consisting of representatives from Investment Accounting, Human Resources, IMD, Legal Services and Internal Audit. This task force, is currently working on developing formal calculation and review procedures. These procedures should include several checks and balances, such as identification of responsible divisions and their responsibilities, designation of primary and secondary persons for each division, reconciliation of information, review of calculations (prior to reporting the amounts to the oversight agencies), and approval of final calculations (before making payments to plan participants).

**TAB 2C**

**QUARTERLY INVESTMENT COMPLIANCE TESTING**  
**INVESTMENT POLICY STATEMENT (IPS), SECURITIES LENDING POLICY (SLP), WIRE TRANSFER PROCEDURES, EMPLOYEE**  
**ETHICS POLICY, AND CODE OF ETHICS FOR CONTRACTORS**  
**CALENDAR QUARTER ENDED DECEMBER 31, 2014, EXCEPT AS NOTED**

<b>Business Objectives</b>	1. <u>Board Reports</u> All required information is reported to the TRS Board of Trustees	2. <u>Investment Selection and Approval</u> Investments made are within delegated limits and established selection criteria	3. <u>Other (IPS, SLP, wire transfers, other reporting)</u> Risk limits are followed for other investment programs and activities	4. <u>Ethics Policies</u> Ethics filing and reporting requirements are met
<b>Business Risks</b>	Board is not informed of key investment decisions and critical information	Approvals and fundings exceed delegated limits	Risks exceed Board established tolerances	Ethics policy requirements are not filed or reported
<b>Management Assertions</b>	All required information is reported to the Board	Approvals and fundings are within delegated limits and made for qualified managers	Programs are within risk limits	Ethics policies and requirements are being followed
<b>Agreed-Upon Procedures</b>	<ul style="list-style-type: none"> <li>Compare Board reports to IPS requirements</li> </ul>	<ul style="list-style-type: none"> <li>Vouch Internal Investment Committee (IIC) approved investments to supporting documentation</li> <li>Verify approval limits of new investments</li> <li>Obtain evidence that Placement Agent Questionnaires (PAQ's) were received prior to investment funding</li> </ul>	<ul style="list-style-type: none"> <li>Validate IMD's reporting of a summary of managers/funds added or removed</li> <li>Validate completeness of wires</li> <li>Validate SLP compliance</li> <li>Obtain senior management and legal staff disclosures about known compliance violations for the four months ended January 31, 2015</li> </ul>	<ul style="list-style-type: none"> <li>Obtain evidence that employee disclosure statements were filed</li> <li>Obtain evidence that contractors filed commencement of business and annual statements and reports</li> </ul>
<b>Test Results</b>	<ul style="list-style-type: none"> <li>All reporting requirements met</li> <li>Documentation provides support for reports tested</li> </ul>	<ul style="list-style-type: none"> <li>All investments tested were in compliance with approval limits</li> <li>The Investment Management Division (IMD) obtained PAQ's for two investments after funding. Neither PAQ indicated that a placement agent was used.</li> </ul>	<ul style="list-style-type: none"> <li>All requirements of the IPS, SLP, wire transfer procedures, etc. are met, except in one instance the IMD reported that two currency derivatives were initially traded with an unauthorized counterparty but were corrected before settlement.</li> </ul>	<ul style="list-style-type: none"> <li>All ethics filing and reporting requirements have been met</li> </ul>
<b>Management Responses</b>	N/A	N/A	N/A	N/A

Legend: **Red** - Significant to TRS    **Orange** - Significant to Business Objectives    **Yellow** - Other Reportable Exception    **Green** - Positive Test Result/ No Exception

March 10, 2015

Carolina de Onis, TRS General Counsel

We have completed the **Quarterly Investment Testing** of compliance with the requirements of the Investment Policy Statement (IPS), Securities Lending Policy (SLP), Employee Ethics Policy, Code of Ethics for Contractors, and procedures for wire transfers as included in the *Fiscal Year 2015 Audit Plan*.

We performed the procedures that were agreed to by the TRS Legal Services division. These procedures include tests that supplement the current compliance monitoring procedures performed by State Street and the Chief Compliance Officer.

This agreed-upon procedures engagement was performed in accordance with generally accepted government auditing standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States.

The sufficiency of the agreed-upon procedures performed is solely the responsibility of the specified users of the report. Consequently, we make no representations regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Our testing procedures and results are included in **Appendix A**.

### **Internal Control Structure**

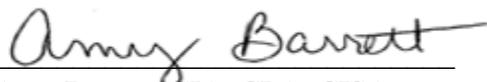
We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas tested.

Had we performed additional procedures, or had we made an examination of the system of internal control, other matters might have come to our attention that would have been reported to you. This report relates only to the procedures specified below and does not extend to the internal control structure.

This report is intended solely for information and use by TRS management, the Board of Trustees, and oversight agencies, and is not intended to be and should not be used by anyone other than those specified parties. However, this report is a matter of public record and its distribution is not limited.

\* \* \* \* \*

We express our appreciation to management and key personnel of the Investment Management Division and Investment Accounting for their cooperation and professionalism shown to us during this quarterly testing.



Amy Barrett, CIA, CPA, CISA  
Chief Audit Executive



Hugh Ohn, CFA, CPA, CIA, FRM  
Director of Investment Audit Services



Nick Ballard, CFA  
Senior Investment Auditor

**APPENDIX A**  
**AGREED-UPON PROCEDURES AND RESULTS**

<b>STEP #</b>	<b>OBJ. #</b>	<b>TEST PURPOSE</b>	<b>TEST DESCRIPTION</b>	<b>TEST RESULT</b>	<b>MANAGEMENT RESPONSE</b>
1	1	IPS Article 1.7 - Obtain evidence that all requirements were reported to Board of Trustees. Quarterly reporting requirements include investment performance, asset class exposures, and external investments under consideration. Semi-annual reports include outstanding derivatives, leverage, and liquidity positions, and risk limits	Obtain copies of all reports required to be reported to Board of Trustees and compare to reporting requirements per Investment Policy Statement (IPS)	Reports required to be reported to Board of Trustees complied with IPS.	No response required
2	2	IPS Article 1.8f – Obtain evidence that TRS complied with Chapters 806 and 807 of the Government Code relating to prohibitions on investments in Sudan and Iran, respectively.	<ul style="list-style-type: none"> <li>• Ensure that responsible staff have updated Sudan/Iran restricted lists</li> <li>• Determine whether TRS complied with the following requirements: (a) to notify the Comptroller’s Office and the Pension Review Board regarding holdings of restricted company securities; (b) to divest holdings; and (c) to file annual report of Sudan/Iran investment activity to the Legislature and the Attorney General</li> </ul>	<ul style="list-style-type: none"> <li>• Investment Compliance staff updated Sudan/Iran restricted lists.</li> <li>• TRS complied with divestment requirements.</li> <li>• TRS complied with the annual report requirements.</li> </ul>	No response required
3	2	IPS Article 3.3f – Obtain evidence of existence of IMD’s prudent underwriting objectives for advisor’s due diligence	Select sample of Private Market investments approved during testing period, obtain evidence of existence of advisor's report stating investment opportunity meets prudent underwriting standards and merits inclusion within respective portfolios	For selected private markets approved investments for the quarter, verified that the prudence letter from the advisor was included in the Internal Investment Committee (IIC) materials.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
4	2	IPS Article 7 – Obtain evidence that new investments in emerging managers meet requirements	<p>Test sample of approved investments to verify:</p> <ul style="list-style-type: none"> <li>• Each is independent private investment management firm with less than \$2 billion</li> <li>• Each has a performance track record as a firm of less than 5 years, or both</li> <li>• TRS commitment did not exceed 40% of fund size</li> </ul>	No emerging managers were approved during the testing period, therefore no investments were available to test compliance with this provision.	No response required
5	2	IPS Article 12 - Obtain evidence of existence of placement agent questionnaire for each new investment selected for testing and test for inclusion in summary report to the Board	<ul style="list-style-type: none"> <li>• For each investment selected for testing, verify that IMD obtained responses to the questionnaire</li> <li>• Determine that IMD compiled responses to the questionnaires and reported all results to the Board at least semi-annually</li> </ul>	In December 2014, IMD made add-on investments in two existing managers without obtaining updated Placement Agent Questionnaires (PAQs) prior to funding the investments. When this issue was identified in January 2015, IMD staff obtained PAQs which confirmed that neither firm engaged a placement agent in connection with the investments.	Management reported this issue and corrective action taken in the February 2015 Transparency Report.
6	2	IPS Appendix B – Obtain evidence that investments approved are within policy limits	<ul style="list-style-type: none"> <li>• Select sample of approved investments and obtain tear sheet for each, observe the approved amounts are within authorized limits <ul style="list-style-type: none"> <li>a) Initial allocation – .50%</li> <li>b) Additional or follow-on – 1%</li> <li>c) Total Manager Limits – 3%</li> <li>d) Total limit each manager organization – 6%</li> </ul> </li> <li>• Obtain documentation from IMD staff that supports the calculations of the authorized limits</li> <li>• Inquire if any “Special Investment Opportunities” were made for the quarter</li> </ul>	For the sample selected for testing, no manager or partner organization exceeded the authorized limits and documentation existed for IMD staff calculations of authorized limits. There were no Special Investment Opportunities.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
7	3	Quarterly Disclosures – Obtain evidence that all known compliance violations have been reported	Send request for disclosure to IMD management, Legal Investment staff, and CIO requesting disclosure of any known compliance violations during the testing period	<ul style="list-style-type: none"> <li>• Obtained all disclosures from IMD management, Legal Investment staff, and CIO of any known compliance violations during the testing period.</li> <li>• During the quarter, the TRS Investment Management Division (IMD) reported that TRS executed two currency transactions with settlement dates greater than 30 days with a counterparty that may only execute currency transactions with settlement dates of less than 30 days. This issue was subsequently corrected by transferring the trade to an authorized counterparty. Staff also reported that they worked to develop a warning notification that will prevent similar errors in the future.</li> </ul>	Management reported this issue and corrective action taken in the January 2015 Transparency Report.
8	3	Wire Transfers – Obtain evidence that TRS Investment Accounting’s record of processed investment funding was complete.	Obtain TRS Investment Accounting investment funding log and reconcile to State Street outgoing wires log to determine if the funding log is complete.	The Investment Accounting funding log reconciled to the State Street Outgoing wires log for the period tested.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
9	3	Securities Lending Policy – Obtain evidence that IMD reviews the securities lending program and performance of lender	<p>Obtain evidence from the monthly securities lending program performance reviews conducted by the TRS Asset Allocation team and the Securities Lending Agent that investments in the securities lending program comply with the following policy requirements:</p> <ul style="list-style-type: none"> <li>a) Collateral pool investments are only in US Government Securities; Money Market Instruments; Repurchase Agreements; and Fixed and Floating Rate Debt Obligations.</li> <li>b) The maturity for fixed rate cash collateral investments does not exceed 36 months, and the maturity for floating rate investments does not exceed seven years.</li> <li>c) The dollar-weighted average maturity of the collective cash collateral investment portfolio does not exceed 120 days.</li> </ul>	The securities lending program monthly reports and performance reviews showed that TRS collateral pool investments complied with the securities lending provisions selected for testing.	No response required
10	4	Employee Ethics Policy – Obtain evidence that the Executive Director and Key Employees filed completed Disciplinary Action Disclosure Statements	Select a sample of TRS Key Employees, including the Executive Director, and determine whether completed Disciplinary Action Disclosure Statements were filed within 60 days of the date of employment and when any action occurs that would cause any answers on the Statement to change.	All employees tested submitted completed Disciplinary Action Disclosure Statements as required in the Employee Ethics Policy.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
11	4	Code of Ethics for Contractors – Obtain evidence that each contractor signed and returned the TRS Code of Ethics for Contractors upon commencement of business with TRS. Obtain evidence that TRS contractors annually signed the Annual Ethics Compliance Statement and filed annual expenditure reports.	Select a sample of current TRS contractors, and determine whether the selected contractors signed and returned a copy of the TRS Code of Ethics for Contractors to TRS upon commencement of business with TRS and whether the contractors signed the TRS Contractor Annual Ethics Compliance Statement annually and filed annual expenditure reports.	All tested TRS contractors signed and returned a copy of the TRS Code of Conduct for Contractors upon commencement of business with TRS. All sampled TRS contractors signed the TRS Contractor Annual Ethics Compliance Statement and filed expenditure reports annually.	No response required

**Note: Testing procedures for the Investment Policy Statement (IPS), Securities Lending Policy (SLP), Employee Ethics Policy, Code of Ethics for Contractors, and wire transfers are for the activity for the quarter ending December 31, 2014 and quarterly disclosures are for the four months ended January 31, 2015.**

TAB 3

**TRS Internal Audit  
Summary of Audit Recommendations Status  
March 2015**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>13-602 Fraud Risk Identification and Prevention Audit*</b>					
	Benefit Accounting - Improve system access reviews to ensure access privileges remain current with job duties	Implemented	Significant	12/2013	12/2013
	Benefit Processing - Improve system access reviews to ensure access privileges remain current with job duties and are appropriately balanced between the need for cross-training staff and the need for restricted access to limit opportunity for fraud	Implemented	Significant	12/2013	9/2013
<b>14-104 Refunds of Inactive and Dormant Accounts*</b>					
	Fraud , Waste, and Abuse Policy (FWAP) refresher training needs to occur for existing employees as required by policy	Implemented	Significant	12/2014	11/2014
	Benefit Accounting department should assess risk and control options for enhancing account safeguards and decreasing the risk of fraudulent account refunds	Implemented	Significant	2/2015	2/2015
	Benefit Processing department should assess risk and control options for enhancing account safeguards and decreasing the risk of fraudulent account refunds	Implemented	Significant	2/2015	2/2015

\*A follow-up audit is included in the Audit Plan for Fiscal Year 2015.

**Significant to Business Objectives**

	<ul style="list-style-type: none"> <li>Past <i>original</i> estimated completion date</li> <li>No management action plan <u>or</u> No progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>Past <i>original</i> estimated completion date</li> <li>Progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li><i>Original</i> estimated completion date has not changed</li> <li>Progress on management action plan</li> </ul>
	Satisfactory implementation of management action plan <u>or</u> Acceptance of risk by management
	Implementation of management action plan pending Internal Audit validation

**Other Reportable**

	<ul style="list-style-type: none"> <li>Past <i>original</i> <u>or</u> first <i>revised</i> estimated completion date</li> <li>No management action plan <u>or</u> No progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>Past <i>original</i> <u>or</u> first <i>revised</i> estimated completion date</li> <li>Progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>Within <i>original</i> <u>or</u> first <i>revised</i> estimated completion date</li> <li>Progress on management action plan</li> </ul>
	Satisfactory implementation of management action plan <u>or</u> Acceptance of risk by management

**TRS Internal Audit  
Summary of Audit Recommendations Status  
March 2015**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>14-104 Refunds of Inactive and Dormant Accounts* (continued)</b>					
	Assign staff to review the MR6020 District 000A Transfer Error List	Implemented	Other Reportable	2/2015	2/2015
	Written procedures need to be updated	Implemented	Other Reportable	2/2015	2/2015
	Research the underlying cause for the secondary verification process not always working as intended	Implemented	Other Reportable	2/2015	2/2015
<b>14-301 FY 2014 Overall IMD Internal Control Opinion</b>					
	The ENR team should tailor the manager and investment certification questionnaires to address ENR-specific topics	In Progress	Other Reportable	2/2015	5/2015
	The ENR team should explore leveraging consultants and expanding consultant coverage to obtain additional services and reporting	In Progress	Other Reportable	8/2015	
<b>14-401 Purchasing and Contract Administration</b>					
	<p>TRS' Contract Administration Manual revision process should ensure:</p> <ul style="list-style-type: none"> <li>➤ revisions are made by a coordinated workgroup across various TRS departments</li> <li>➤ the competitive selection process is well defined and new procedures are inclusive of various procurement processes</li> <li>➤ new procedures include a clear process for documenting the justification and approval for all exceptions</li> </ul>	In Progress	Other Reportable	9/2015	6/2015
	TRS' Contract Administration Manual should have a coaching component for all contract sponsors, their designees, and anyone involved in procurement at TRS. Coaching should be provided to the Board and include information regarding fiduciary responsibility and TRS fiduciary obligation.	In Progress	Other Reportable	12/2015	6/2015
	TRS' Contract Administration Manual should have a monitoring component to ensure compliance with the revised Contract Administration Manual and a method for follow-up and/or escalation of non-compliance.	In Progress	Other Reportable	9/2015	6/2015
	The Purchasing Department should update written procedures to match current and new processes	In Progress	Other Reportable	10/2015	6/2015

**TRS Internal Audit  
Summary of Audit Recommendations Status  
March 2015**

<b>Project</b>	<b>Recommendation</b>	<b>Status</b>	<b>Issue Type</b>	<b>Estimated Date</b>	<b>Revised / Actual Date</b>
<b>14-401 Purchasing and Contract Administration (continued)</b>					
	Financial Services management should work with Legal Services to improve control over who is authorized to obligate TRS during purchasing or contracting activities	In Progress	Other Reportable	2/2015	6/2015
	Improve central contract files to include all necessary documentation and train purchasing staff and contract sponsors on these requirements. Implement an escalation process to ensure required documentation is provided to the owner of the contract file.	In Progress	Other Reportable	12/2014	6/2015
	Update TRS record retention schedules to clearly define who the official record holders are for all contracts and related documentation.	In Progress	Other Reportable	2/2015	6/2015

**TAB 4**

**Teacher Retirement System of Texas**  
**March 2015 Audit Committee Agenda Items Mapped to TRS Stoplight Report**

403(b)	Accounting & Reporting	Active Health Care Sustainability	Budget	Business Continuity
Communications & External Relations	Credit	Customer Service	Employer Reporting	<b><i>Ethics &amp; Fraud Prevention</i></b> <b>Agenda Item 2C</b>
Facilities Planning	Governmental/ Association Relations & Legislation	Health Care Administration	Information Security & Confidentiality	<b><i>Investment Accounting</i></b> <b>Agenda Item 2B</b>
Investment Operations	Legacy Information Systems	<b><i>Liquidity/Leverage</i></b> <b>Agenda Item 2B</b>	Market	<b><i>Open Government</i></b> <b>Agenda Items 3, 4</b>
Pension Benefit Administration	Pension Funding	<b><i>Purchasing &amp; Contracts</i></b> <b>Agenda Item 2A</b>	Records Management	<b><i>Regulatory, Compliance &amp; Litigation</i></b> <b>Agenda Item 2C</b>
Retiree Health Care Funding	TEAM Program	Workforce Continuity		

## Status of Fiscal Year 2015 Planned Assurance, Consulting, and Advisory Services as of March 2015

Title and Project #	Type	Status
<b>Executive</b>		
University of Texas Students' Projects (15-606A)	Consulting	<b>In Progress</b>
Internal Ethics and Fraud Hotline Administration	Advisory	<b>Ongoing</b>
Meetings Participation	Advisory	<b>Ongoing</b>
Special Requests	Advisory	
<b>Finance</b>		
Payables Audit (15-403)	Audit	<b>Complete</b>
Actuarial Data Controls (14-402)	Audit	<b>In Progress</b>
Reporting Entity Audits and Investigations (15-401)	Audit	<b>In Progress</b>
Business Process Analysis of Activities Involving Multiple Departments (15-404)	Consulting	<b>Complete</b>
TRS Reporting Entity Website Audit Information	Advisory	<b>Complete</b>
State Auditor's Office (SAO) Financial (CAFR) Audit Coordination	Advisory	<b>Complete</b>
Meetings Participation	Advisory	<b>Ongoing</b>
Special Requests and Surprise Inspections	Advisory	
<b>TEAM Program</b>		
TEAM Program Internal Controls Assessment (15-601)	Advisory	<b>Delayed Due to LOB Project Schedule Delay</b>
TEAM Independent Program Assessment (IPA) Vendor Support	Advisory	<b>Ongoing</b>
TEAM Committees and TEAM Projects Participation	Advisory	<b>Ongoing</b>
<b>Pension Benefits</b>		
Follow-Up Audit on Significant Findings of Prior Benefits Audits (15-102)	Audit	
Benefits Testing for State Auditor's Office (SAO) Audit of Comprehensive Annual Financial Report (CAFR) (15-100)	Audit	<b>Complete</b>
Semi-Annual Benefits Testing (11-501)	Agreed-Upon Procedures	<b>In Progress</b>
<b>Health Care</b>		
Health Care Audit Services Review	Advisory	<b>Complete</b>
Health Care Vendor Selection Observation	Advisory	
Health Care Vendor Update Meetings	Advisory	<b>Ongoing</b>

## Status of Fiscal Year 2015 Planned Assurance, Consulting, and Advisory Services as of March 2015

Title and Project #	Type	Status
<b>Information Technology</b>		
Electronic Records (15-501)	Audit	
Cloud Computing, Mobile Device Security, Co-Location/Disaster Recovery, IT Security	Consulting and Advisory	<b>In Progress</b>
Network Penetration Test; Security Risk Assessment Review	Advisory	
Technology Committees Meeting Participation	Advisory	<b>Ongoing</b>
<b>Investment Management</b>		
Overall Internal Control Opinion on Investment Activities (includes periodic status reports) (15-301)	Audit	<b>In Progress</b>
Quarterly Investment Compliance and Ethics Policies Testing (15-302)	Agreed-Upon Procedures	<b>1<sup>st</sup>, 2<sup>nd</sup> Quarters Complete</b>
Emerging Risks Reviews	Advisory	<b>Ongoing</b>
Incentive Compensation Plan Review	Advisory	<b>Complete</b>
Investment Committees Attendance	Advisory	<b>Ongoing</b>
<b>Internal Audit Department</b>		
Annual Internal Audit Report (15-603)	Audit	<b>Complete</b>
Quarterly Audit Recommendations Follow-up	Audit	<b>Ongoing</b>
Internal Quality Assurance Review	Advisory	<b>In Progress</b>
Fiscal Year 2016 Audit Plan	Advisory	
Internal Audit Vendor Request for Qualifications (RFQ) – Health Care Audits	Advisory	
Audit Committee Meetings Preparation	Advisory	<b>Ongoing</b>

**Fiscal Year 2015 Internal Audit Advisory Services<sup>1</sup>  
December 2014 – February 2015**

<b>BENEFIT SERVICES</b>
<p><b>TEAM PROJECT PARTICIPATION</b></p> <ul style="list-style-type: none"> <li>• Executive Steering Committee</li> <li>• Budget Committee</li> <li>• Data Management Project</li> <li>• Decommissioning Project</li> <li>• Security Architecture monthly meetings</li> <li>• Organizational Change Management Advisory Group</li> <li>• Business Procedures and Training Project</li> <li>• Detailed Level Requirements Reviews – Refunds, Member Account Maintenance, General Line of Business, Reporting Entity Reporting</li> <li>• Monthly meetings with TEAM Project Manager</li> <li>• Core Management Team: Standing Prioritization Review Meeting</li> <li>• Independent Program Assessment Vendor Coordination and Support</li> </ul>
<b>HEALTH BENEFITS</b>
<ul style="list-style-type: none"> <li>• Health Plan Administrator (HPA) and Pharmacy Benefit Manager (PBM) Vendor Quarterly Update Meeting Participation</li> <li>• Comments provided on draft RFP for HPA and PBM audit services</li> </ul>
<b>INVESTMENTS</b>
<ul style="list-style-type: none"> <li>• Coordination of State Auditor’s Office audit of incentive compensation</li> <li>• Internal Investment Committee (IIC) Attendance</li> <li>• Internal Public Markets (IPM) Performance Analysis Meeting Participation for Incentive Pay Plan</li> <li>• Participation in Executive Director’s Incentive Compensation Plan Task Force</li> <li>• Monthly meetings with the Investment Compliance team (Chief Compliance Officer and Senior Compliance Specialist)</li> <li>• Update Meetings with Chief Risk Officer</li> </ul>
<b>FINANCIAL SERVICES</b>
<ul style="list-style-type: none"> <li>• Coordination of State Auditor’s Office (SAO) Audit of TRS’ Fiscal Year 2014 Comprehensive Annual Financial Report including census data testing and GASB 68 schedules</li> <li>• Coordination of SAO audit of proportionality controls</li> <li>• Consulting on select business processes within the Finance Division</li> </ul>
<b>EXECUTIVE</b>
<ul style="list-style-type: none"> <li>• State Auditor’s Office Quarterly Update Meetings Coordination and Support</li> <li>• Hot Line Call Facilitation</li> <li>• Social Media Committee</li> <li>• Executive Requests</li> </ul>
<b>INFORMATION TECHNOLOGY (IT)</b>
<ul style="list-style-type: none"> <li>• Co-Location Service Team Participation</li> <li>• Cloud Computing Committee Participation</li> <li>• ERM Data Protection Project</li> </ul>

<sup>1</sup> Advisory Services (non-audit services) - The scope of work performed does not constitute an audit under Generally Accepted Government Auditing Standards (GAGAS).

**Internal Audit Goals and Performance Measures - Fiscal Year 2015  
2nd Quarter Ending February 28, 2015**

Target Performance	Activity	Status
<b>Goal 1: Enhance Effectiveness of Internal Audit Organization</b>		
1. Spend a minimum of 75% of total available department hours (excludes uncontrollable leave) for professional staff on direct assurance, consulting, and advisory services.	Achieved 81% for year to date fiscal year 2015	On Task
2. Complete an internal self-assessment and report annually on the results of the Quality Assurance and Improvement Program.	Internal self-assessment is in progress and will be reported in the 4 <sup>th</sup> quarter.	On Task
<b>Goal 2: Develop and Implement Internal Audit Annual Audit Plan based on Formal Risk Assessment</b>		
3. Prepare an annual audit plan based on a documented risk assessment and obtain input from trustees and staff.	Audit planning and risk assessment is scheduled for the 4 <sup>th</sup> quarter.	On Task
4. Execute 80% of audit and agreed-upon procedures projects (80% allows for flexibility due to changes in TRS business practices and special requests).	Planned assurance and agreed-upon procedures projects are on schedule and assigned to staff	On Task
5. Prepare a formal reporting entity risk assessment to identify reporting entities for audit.	Internal Audit staff has completed a formal risk assessment and audits of reporting entities are underway.	On Task
<b>Goal 3: Enhance Internal Audit Staff Skills and Knowledge in Emerging Risks and Controls with Emphasis on Information Technology, Investment and Health Care</b>		
6. Enhance staff knowledge of services provided to the Investment Management Division by visiting one TRS asset manager or service provider	Open – to be scheduled	On Task
7. Engage a service provider for conducting or co-sourcing health care audits	Open – to be scheduled	On Task
<b>Goal 4: Deliver Value-Added Consulting and Advisory Activities</b>		
8. Facilitate coordination of TEAM Independent Program Assessment (IPA) Vendor by coordinating meetings with Executive Director, Executive Steering Committee (ESC) and Core Management Team (CMT), quarterly presentations to the TRS Board of Trustees, and other contractual activities.	Coordination and support of IPA vendor is ongoing	On Task

**Internal Audit Goals and Performance Measures - Fiscal Year 2015  
2nd Quarter Ending February 28, 2015**

Target Performance	Activity	Status
9. Facilitate timely completion and success of State Auditor’s Office (SAO) audits in fiscal year 2015 by effectively providing audit support, coordinating meetings, reserving facilities and gathering schedule and documentation requests.	Internal Audit staff is currently providing audit and coordination support for SAO audit of proportionality controls and SAO audit of incentive compensation.	On Task
<b>Goal 5: Enhance Participation in Professional and Peer Organizations</b>		
10. Participate in professional organizations (APPFA, IIA, ISACA, ACFE, SAIAP, CFA Institute) through monthly chapter meetings and participate in leadership roles in at least two of the professional organizations	The CAE is secretary for APPFA and IT Audit Manager is the web administrator for APPFA. One audit manager is on the Board of Governors for the Austin Chapter of the IIA. Participation in professional organizations is ongoing.	On Task
11. Support staff in obtaining additional certifications including the CFA, CPA, and CIA certifications and have a minimum of two staff seek additional professional certifications in fiscal year 2015.	Two staff members are currently preparing for professional certifications exams.	On Task

**Legend: Target Status**

-  Target not achieved
-  Behind in achieving target
-  On task to achieve target
-  Achieved target

## Spreading Sunshine in Private Equity

### **Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations**

**Private Equity International (PEI), Private Fund Compliance Forum 2014  
New York, NY**

**May 6, 2014**

### **Introduction**

Good morning, and thank you very much for that kind introduction. *Before I begin, I'll remind you that the Securities and Exchange Commission disclaims responsibility for any statement or private publication by any of its employees, including me. The views expressed here are my own and do not necessarily reflect the views of the Commission, the Commissioners, or of other members of the staff.*

I want to thank Private Equity International for giving me the opportunity to speak with you at an interesting moment in private equity regulation.<sup>[1]</sup>

According to at least one industry source,<sup>[2]</sup> since the beginning of the millennium, the private equity industry's assets under management, defined as the uncalled capital commitments plus the market value of portfolio assets, have increased year after year. With the industry-wide portfolio value increasing steadily, and dry powder remaining around the \$1 trillion mark, private equity assets under management are higher than they've ever been at just under \$3.5 trillion as of June 30, 2013.

In addition, over the last two years, many of your firms have registered with the Commission and are operating as regulated entities. I am hopeful that regulation will have a positive effect on your firms and your industry. Intelligent regulation can enable an asset class to grow by increasing investor confidence in investment models, programs, and products, including those offered by private equity firms.

Within OCIE, we have been sharpening our understanding of the private equity industry and our strategies to engage with you to fulfill our important mission to protect investors and the integrity of our markets. I want to take this opportunity to speak today to share where OCIE is in its efforts to engage with the private equity industry and also to share some insights we have learned from the examinations of private equity advisers we have conducted over the last two years.

### **OCIE and Presence Exams**

OCIE consists of approximately 900 examiners who go out into the world and directly engage with registrants for the purpose of collecting information for the Commissioners and our colleagues on the staff. We are the "eyes and ears" of the Commission. We are responsible for conducting examinations of more than 25,000 registrants, including approximately 11,000 registered investment advisers, of which at least 10% provide services to at least one private equity fund.

We are well prepared and equipped to conduct these exams. Many of our examiners have conducted private equity exams. We have also added individuals with private equity expertise to our team. We maintain a specialized working group of private equity experts across the

Commission, who help us identify issues, develop examination modules, evaluate exam findings, and conduct training. You may have also seen that we are forming a special unit of examiners, who will focus on leading examinations of advisers to private funds.

## **Presence Exam Initiative**

The Presence Exam Initiative is an important part of our strategy to engage with the private equity industry. The initiative commenced in October 2012 and is nearly complete. As the name suggests, we designed the initiative to quickly establish a presence with the private equity industry and to better assess the issues and risks presented by its unique business model. We began by reaching out to the industry, publishing letters, and appearing at events like this to share information about regulatory obligations and to be as transparent as possible about where we see risks and where we therefore intended to probe, to test, and to ask questions during examinations.

Some questioned why we would show our hand in this way, to which there's a simple and sensible answer. We believe that most people in the industry are trying to do the right thing, to help their clients, to grow their business, and to provide for their owners and employees. We therefore believe that we can most effectively fulfill our mission to promote compliance by sharing as much information as we can with the industry, knowing that people will use it to measure their firms and to self-correct where necessary. Put another way, we are not engaged in a game of "gotcha."

Which reminds me of a story and formative experience. Many, many years ago, I had the pleasure of serving on the Ocean City, Maryland beach patrol. As a new guard, or a "green bean" as we were called, I was assigned to apprentice with a sun-worn, grizzled veteran. One of the first things he explained to me was that because the Beach Patrol measured "pulls," or how many endangered swimmers a guard pulled from hazard, there were some guards who would watch idly while swimmers, through ignorance or neglect, swam themselves into danger, so the guard could jump from the stand and save them. My mentor explained the more effective, responsible approach was to work hard to prevent swimmers from getting into trouble in the first place. He encouraged me to hop off my stand, to speak with swimmers, and to warn them while they were still near shore or a safe distance from a jetty or riptide. The most effective guard, he explained, should rarely have to make a pull.

The same principle was behind our Presence Exam strategy and much of what we do every day, and it's behind the information I am sharing today, some of which is not flattering. I share it not to embarrass or to wag a finger, but to educate so all of the good people in attendance (or reading this speech) can test for and, if necessary, address within their organizations the types of problems we have seen across the industry.

After engaging with the industry in the initial phase of the Presence Exam Initiative, we commenced examinations. At this point, we have initiated examinations of more than 150 newly registered private equity advisers. We are on track to complete our goal of examining 25% of the new private fund registrants by the end of this year. Based on the feedback we have received, we believe the initiative has been effective and well received. (I welcome your candid feedback in this regard, whether it is consistent with, or contradicts, our belief.) The exams we have conducted to date have also led to some interesting insights, which I'll discuss in a moment.

## **Trends in Private Equity Industry**

Many people ask how we determine our private equity exam priorities and risk areas. For starters, we analyze the incentives created by various industry structures and trends and use that analysis to determine where compliance failures are most likely to occur. We conduct exams, test our hypotheses, and learn. As the industry structures and trends shift, so too does our view of compliance risks.

## **Inherent Risks in Private Equity**

When we look at the private equity business model, we see some risks and temptations that are not present in the more common adviser model where an adviser buys and sells shares of publicly traded companies.

A typical buy-side adviser uses client funds to buy shares in a publicly traded company. The adviser can vote proxies and may engage with management and the board up to point ... but absent taking some extraordinary steps, the adviser's ability to influence or control the company is generally constrained. If the adviser jumps through the hoops necessary to attempt to influence or control the company, and accumulates (alone or with others) enough shares to pull it off, its control and the changes it intends to make are generally visible to its clients and the public at large.

The private equity model is very different. A private equity adviser typically uses client funds to obtain a controlling interest in a non-publicly traded company. With this control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend. For example, the private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services ... or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company ... or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.

We have seen that these temptations and conflicts are real and significant.

Next, I'd like to identify some aspects of the industry that not only make it difficult to mitigate these risks, but also may enable them to flourish.

## **Limited Partnership Agreements**

General Partners often point to the heavily negotiated and voluminous limited partnership agreement as a source of investor protection. But we've seen limited partnership agreements lacking in certain key areas.

Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser).

This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of exam findings. We've also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.

Finally, and most importantly, we see that most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager. Of course, many managers voluntarily

provide important information and disclosures to their investors, but we find that broad, imprecise language in limited partnership agreements often leads to opaqueness when transparency is most needed.

## **Lack of Transparency**

Lack of transparency and limited investor rights have been the norm in private equity for a very long time. While investors typically conduct substantial due diligence *before* investing in a fund, we have seen that investor oversight is generally much more lax *after* closing.

There could be many reasons for this. Investors may not be sufficiently staffed to provide significant oversight of managers. When they are, and even when they conduct rigorous due diligence up front, they often take a much more hands-off approach after they invest their money and funds are locked up. This is especially true when managers have completed their investment period and the investor does not plan to reinvest. There is a high cost to initiating action among limited partners, especially after their capital has been substantially drawn and when there are many investors in a fund, who are difficult to organize or even identify. Or, there may be a mistaken belief that auditors will provide sufficient oversight to protect investors' interests.

So ... when we think about the private equity business model as a whole, without regard to any specific registrant, we see unique and inherent temptations and risks that arise from the ability to control portfolio companies, which are not generally mitigated, and may be exacerbated, by broadly worded disclosures and poor transparency.

## **Industry Trends**

Finally, in OCIE we see some current developments in the industry that appear to be generating pressure on private equity firms and heightening the risk of a misalignment of interests between advisers and investors. Although the capital raising market has substantially improved since the lowest points in 2009 and 2010, there still appears to be a consolidation and shake out in the industry. This has created several issues.

First, we continue to see "zombie" advisers, or managers that are unable to raise additional funds and continue to manage legacy funds long past their expected life. These managers are incentivized to continue to profit from their current portfolio even though that may not be in the best interest of investors. These managers may increase their monitoring fees, shift more expenses to their funds or try to push the envelope in their marketing material by increasing their interim valuations, sometimes inappropriately and without proper disclosure.

Next, consolidation will also produce some winners — advisers that are able to rapidly grow their assets under management — and we are seeing the emergence of larger managers, which have additional and different business lines, products, and stake holders than an adviser that only manages private equity funds. Most of these managers have grown up managing purely private equity vehicles, and some are having difficulty adjusting to the complexities and inherent conflicts of interest of their new business model.

OCIE's experience is that complexity and rapid growth have created governance and compliance issues that should be addressed as these firms mature and evolve. For example, we have seen that much of the growth in private equity is not coming from the traditional co-mingled vehicles but from separate accounts and side-by-side co-investments. These accounts, which invest alongside the main co-mingled vehicle, are often not allocated broken deal expenses or other costs associated with generating deal flow. This may be occurring because the rapidly growing adviser has not yet updated its policies and procedures to be able to handle separate accounts or because the adviser

may not have invested sufficient capital in the back-office to be able to perform a proper allocation. Whatever the reason, it's clear that in many instances these firms' compliance functions are not growing as quickly as their businesses.

Also, despite the relatively successful performance of the private equity industry, we have observed returns begin to compress and converge. As a result, fewer managers will be able to overcome their preferred return and collect carried interest, which heightens the risk that managers may attempt to make up that shortfall in revenue by collecting additional fees or shifting expenses to their funds. As I'll discuss shortly, this has been a significant issue that OCIE has seen in our private equity registrant population.

## Examination Observations

With some of these industry dynamics as a backdrop, I'll discuss a few of the observations from the more than 150 exams of private equity advisers that we have conducted to date.

### Expenses

By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.

This is a remarkable statistic. Historically, the most frequently cited deficiencies in adviser exams involve inadequate policies and procedures or inadequate disclosure. This makes sense because virtually any primary deficiency can be coupled with a secondary deficiency for failing to maintain policies and procedures to prevent the primary deficiency or failing to disclose the primary deficiency to clients. And the deficiency rate for these two most commonly cited deficiencies usually runs between 40% and 60% of all adviser examinations conducted, depending on the year. So for private equity firms to be cited for deficiencies involving their treatment of fees and expenses more than half the time we look at the area is significant.

Some of the most common deficiencies we see in private equity in the area of fees and expenses occur in firm's use of consultants, also known as "Operating Partners," whom advisers promote as providing their portfolio companies with consulting services or other assistance that the portfolio companies could not independently afford. The Operating Partner model is a fairly new construct in private equity and has arisen out of the need for private equity advisers to generate value through operational improvements. Many limited partners view the existence of Operating Partners as a crucial part of their investment thesis when they allocate to private equity funds, largely because the Operating Partner model has proven to be effective.

Many of these Operating Partners, however, are paid directly by portfolio companies or the funds without sufficient disclosure to investors. This effectively creates an additional "back door" fee that many investors do not expect, especially since Operating Partners often look and act just like other adviser employees. They usually work exclusively for the manager; they have offices at the manager's offices; they invest in the manager's funds on the same terms as other employees; they have the title "partner"; and they appear both on the manager's website and marketing materials as full members of the team. Unlike the other employees of the adviser, however, often they are not paid by the adviser but instead are expensed to either the fund or to the portfolio companies that they advise.

There are at least two problems with this. First, since these professionals are presented as full members of the adviser's team, investors often do not realize that they are paying for them *a la carte*, in addition to the management fee and carried interest. The adviser is able to generate a

significant marketing benefit by presenting high-profile and capable operators as part of its team, but it is the investors who are unknowingly footing the bill for these resources. Second, most limited partnership agreements require that a fee generated by employees or affiliates of the adviser offset the management fee, in whole or in part. Operating Partners, however, are not usually treated as employees or affiliates of the manager, and the fees they receive therefore rarely offset management fees, even though in many cases the Operating Partners walk, talk, act, and look just like employees or affiliates.

Another similar observation is that there appears to be a trend of advisers shifting expenses from themselves to their clients during the middle of a fund's life — without disclosure to limited partners. In some egregious instances, we've observed individuals presented to investors as employees of the adviser during the fundraising stage who have subsequently being terminated and hired back as so-called "consultants" by the funds or portfolio companies. The only client of one of these "consultants" is the fund or portfolio company that he or she covered while employed by the adviser. We've also seen advisers bill their funds separately for various back-office functions that have traditionally been included as a service provided in exchange for the management fee, including compliance, legal, and accounting — without proper disclosure that these costs are being shifted to investors.

More commonly, we see advisers using process automation as a vehicle to shift expenses. For instance, it is becoming commonplace to automate the investor reporting function. Where, in the past, adviser employees compiled portfolio company information and distributed reports, now a software package captures operating data directly from the portfolio companies and distributes investor reports automatically. There's certainly nothing wrong with this development that makes private equity advisers more efficient. But the costs of this efficiency gain, including the cost of the software and its implementation, are often borne not by the adviser, who is responsible for preparing and delivering the reports, but by investors when the funds are charged, contrary to the reasonable expectation of the limited partners under a fair reading of the limited partnership agreement.

## **Hidden Fees**

The flipside of expense-shifting is charging hidden fees that are not adequately disclosed to investors.

One such fee is the accelerated monitoring fee. Monitoring fees, as most limited partners know, are commonly charged to portfolio companies by advisers in exchange for the adviser providing board and other advisory services during the portfolio company's holding period. What limited partners may not be aware of is that, despite the fact that private equity holding periods are typically around five years, some advisers have caused their portfolio companies to sign monitoring agreements that obligate them to pay monitoring fees for ten years ... or longer. Some of these agreements run way past the term of the fund; some self-renew annually; and some have an indefinite term. We see mergers, acquisitions, and IPOs triggering these agreements. At that point, the adviser collects a fee to terminate the monitoring agreement, which the adviser caused the portfolio company to sign in the first place. The termination usually takes the form of the acceleration of all the monitoring fees due for the duration of the contract, discounted at the risk-free rate. As you can imagine, this sort of arrangement has the potential to generate eight-figure, or in rare cases, even higher fees. There is usually no disclosure of this practice at the point when these monitoring agreements are signed, and the disclosure that does exist when the accelerations are triggered is usually too little too late.

There are other troubling practices in the hidden fee arena including:

- Charging undisclosed “administrative” or other fees not contemplated by the limited partnership agreement;
- Exceeding the limits set in the limited partnership agreement around transaction fees or charging transaction fees in cases not contemplated by the limited partnership agreement, such as recapitalizations; and
- Hiring related-party service providers, who deliver services of questionable value.

The Commission’s Enforcement Division recently filed a case<sup>[3]</sup> against a Manhattan-based private equity manager, alleging the misappropriation of more than \$9 million from investors in a private equity fund. The investigation is still continuing, but the Enforcement staff obtained an emergency court order to freeze assets and alleged that the manager had schemed with a longtime acquaintance to set up a sham due diligence arrangement. The manager is alleged to have used fund assets to pay fees to a front company controlled by his acquaintance. The fees received by the front company were supposed to be used to conduct due diligence for the fund on potential investments. Instead, the money was allegedly kicked back (indirectly) to the private equity manager, and he is alleged to have spent it for other purposes. For example, he allegedly paid hefty commissions to third parties to secure investments from pension funds. He also allegedly rented luxury office space and used the funds to project the false image that his firm was a thriving international private equity operation.

## **Marketing and Valuation**

The final set of OCIE’s observations I want to discuss have to do with marketing and valuation. Since the private equity fundraising market continues to be tight for some advisers, we expect marketing to continue to be a key risk area even as the overall market improves.

Over the past several years, there has been an industry discussion about the relevance of interim valuations. The industry has argued that since management fees are not based on interim valuations, the role of interim valuations is limited. Last year at this conference, Bruce Karpati, then of the SEC’s Enforcement Division, addressed this debate, noting the importance of valuations in fund marketing. Academic studies have supported this thesis, showing that some advisers inflate valuations during periods of fundraising.<sup>[4]</sup> Valuation, of course, is a clear signal to investors about the health of an adviser’s most current portfolio, which may be the most relevant to an investor considering whether to invest in a current offering.

A common valuation issue we have seen is advisers using a valuation methodology that is different from the one that has been disclosed to investors. The Division of Enforcement recently settled a case<sup>[5]</sup> against a New York-based private equity manager based on allegations that he misled investors and potential investors with respect to the value of a fund-of-funds that he managed. Enforcement alleged that the manager disseminated quarterly reports and marketing materials, which wrongly stated that the valuation of the fund-of-fund’s holdings was based on values that were received from the portfolio manager of each of the underlying funds. In fact, the manager allegedly valued the fund’s largest investment at a significant markup to the underlying manager’s estimated value. He also sent marketing materials reporting an internal rate of return that failed to deduct fees and expenses. That one change in valuation methodology caused a huge change in the interim performance of a fund that was still being marketed to prospective investors. As a result of the change in valuation methodology, the fund’s reported gross internal rate of return was enhanced — in one quarter, from roughly 3.8% to more than 38%.

Some of you may be under the mistaken impression that when our exams focus on valuation, our aim is to second-guess your assessment of the value of the portfolio companies that your funds own ... to challenge that a portfolio company is not worth X, but X minus 3%. We are not, except in instances where the adviser's valuation is clearly erroneous.

Rather, our aim and our exams are much more focused. Because investors and their consultants and attorneys are relying on the valuation methodology that an adviser promises to employ, OCIE examiners are scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors. Some things our examiners are watching out for are:

- Cherry-picking comparables or adding back inappropriate items to EBITDA — especially costs that are recurring and persist even after a strategic sale — if there are not rational reasons for the changes, and/or if there are not sufficient disclosures to alert investors.
- Changing the valuation methodology from period to period without additional disclosure — even if such actions fit into a broadly defined valuation policy — unless there's a logical purpose for the change. For instance, we have observed advisers changing from using trailing comparables to using forward comparables, which resulted in higher interim values for certain struggling investments. While making such changes is not wrong in and of itself, the change in valuation methodology should be consistent with the adviser's valuation policy and should be sufficiently disclosed to investors.

In addition to valuation, our examiners are reviewing marketing materials to look for other inconsistencies and misrepresentations. Some areas of particular focus are: performance marketing, where projections might be used in place of actual valuations — without proper disclosure; and misstatements about the investment team. We especially focus on situations where key team members resign or announce a reduced role soon after a fundraising is completed, raising suspicions that the adviser knew such changes were forthcoming but never communicated them to potential investors before closing.

## Developing Compliance Programs

Based on these observations, it's fair to say that there's more work to be done in the private equity industry to bring controls and disclosures in line with existing requirements and investor expectations. As compliance professionals, you and your senior leadership are tasked with ensuring that your firm is not only compliant with the technical requirements of the law, but is also treating its clients and investors fairly, equitably, and in accordance with its status as a fiduciary.

I gave a speech a few weeks ago, where I mentioned the three ways where I see registrants encountering problems with the Commission, clients, plaintiffs' attorneys, and sometimes, criminal authorities: outright fraud, reckless behavior, and conflicts of interest. The most effective defense your firms have against such risks is a strong culture of compliance that is supported by the owners and principals of a firm and reinforced through an independent, empowered compliance department.

It all starts at the top. A compliance department has the best chance of success if management is fully supportive of compliance efforts and provides the CCO with the resources needed to do an effective and thorough job. Additionally, strength and effectiveness of a compliance department is boosted when compliance officers not only understand relevant laws and rules, but are integrated into a firm's business. In OCIE, we've seen that compliance officers, who — for example — participate in weekly deal meetings and in meetings with investors, or who review deal memos, tend to be more effective in spotting issues early and are more respected in their organizations. As a result, we generally see their firms tending to be more compliant.

Invariably, compliance issues will arise at your organizations. Whether those issues develop into larger risks to the firm and investors will in large part depend on whether you are not only empowered to spot those issues but also to raise and to assist in resolving them. Ultimately, a healthy compliance program should make your firm and the entire private equity industry more attractive to investors.

## Why Is OCIE Focusing on Private Funds?

Before I close, I want to address some questions that I'm often asked: Why is OCIE spending resources on private funds? Investors in hedge funds and private equity funds are "big boys" that can take care of themselves. Why not devote more resources to helping "mom and pop" investors?

I have a few responses.

First, the Private Equity Growth Capital Council ("PEGCC") itself has identified the number one myth about private equity as the myth that private equity only benefits wealthy investors.<sup>[6]</sup> "Mom and pop" are much more invested in these funds than people realize. PEGCC states it best: "Private equity investment provides financial security for millions of Americans from all walks of life. The biggest investors in private equity include public and private pension funds, endowments and foundations, which account for 64% of all investment in private equity in 2012." To the extent private equity advisers are engaged in improper conduct, it adversely affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S.

Next, the results of our exams indicate that because of the structure of the industry, the opaqueness of the private equity model, the broadness of limited partnership agreements, and the limited information rights of investors, we are perceiving violations despite the best efforts of investors to monitor their investments. They often have little to no chance of detecting the kinds of issues I discussed today on their own. So, if we're not on the job, doing exams in this area and spreading sunshine, these problems — which involve significant sums of money — are more likely to persist.

## Conclusion

In conclusion, we hope that sharing our exam observations of private equity advisers is helpful to investors and enables them to ask more and better questions before investing and after investments are made, and, in particular, to request more and better disclosure about the fees and expenses that they will pay in addition to the management fee and carried interest.

We also hope that our observations are helpful to the private equity industry. Consider it OCIE hopping down off the beach stand, wading waist-deep into the water, and offering that we see unique risks — riptides and jetties — inherent in your business model. Based on our observations of the controls and disclosures currently in place to mitigate these risks, we advise that you work to strengthen your strokes and pay greater attention and give wider berth, to the potential problems that could harm your clients and your businesses, as well as the private equity industry as a whole.

I believe that if we each do our part to develop an effective regulatory scheme and compliance standard that protects investors and the U.S. financial markets — and also works with your business model — you will see that the additional confidence will allow you to access new markets and to continue to grow the private equity industry, which is a crucial part of the American and global economy.

Thank you.

[1] I would also like to thank the OCIE examiners who so diligently and energetically conducted the exams that form the basis of this talk and especially my colleagues, Elizabeth Blase and Igor Rozenblit, for their substantial and cheerful assistance in preparing these remarks.

[2] 2014 Preqin Global Private Equity Report, at 6, *available at*:  
<https://www.preqin.com/item/2014-preqin-global-private-equity-report/1/8194>.

[3] *SEC v. Lawrence E. Penn, III, Michael St. Altura Ewers, Camelot Acquisitions Secondary Opportunities Management, LLC, the Camelot Group International, LLC and Ssecurion LLC*, (Jan. 30, 2014). Press release and complaint available at:  
<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540703682>.

[4] *See, e.g.*, Tim Jenkinson, Miguel Sousa, and Rüdiger Stucke, "How Fair are the Valuations of Private Equity Funds?" (Feb. 27, 2013); *see also* Barber and Yasuda, "Interim Fund Performance and Fundraising in Private Equity" (Nov. 18, 2013).

[5] *In the Matter of Brian Williamson*, File No. 3-15430 (Jan. 22, 2014), *available at*:  
<http://www.sec.gov/litigation/admin/2014/33-9515.pdf>.

[6] Private Equity Growth Capital Council, "Fact and Fiction," *available at*:  
<http://www.pegcc.org/education/fact-and-fiction/>.

Last modified: May 6, 2014

**RETIREMENT**

## Behind Private Equity's Curtain

By **GRETCHEN MORGENSON** OCT. 18, 2014

From New York to California, Wisconsin to Texas, hundreds of thousands of teachers, firefighters, police officers and other public employees are relying on their pensions for financial security.

Private equity firms are relying on their pensions, too. Over the last 10 years, pension funds have piled into private equity buyout funds. But in exchange for what they hope will be hefty returns, many pension funds have signed onto a kind of omerta, or code of silence, about the terms of the funds' investments.

Consider a recent legal battle involving the Carlyle Group.

In August, Carlyle settled a lawsuit contending that it and other large buyout firms had colluded to suppress the share prices of companies they were acquiring. The lawsuit ensnared some big names in private equity — Bain Capital, Kohlberg Kravis Roberts and TPG, as well as Carlyle — but one by one the firms settled, without admitting wrongdoing. Carlyle agreed to pay \$115 million in the settlement. But the firm didn't shoulder those costs. Nor did Carlyle executives or shareholders.

Instead, investors in Carlyle Partners IV, a \$7.8 billion buyout fund started in 2004, will bear the settlement costs that are not covered by insurance. Those investors include retired state and city employees in California, Illinois, Louisiana, Ohio, Texas and 10 other states. Five New York City and state pensions are among them.

The retirees — and people who are currently working but have accrued benefits in those pension funds — probably don't know that they are responsible for these costs. It would be very hard for them to find out: Their legal obligations are detailed in private equity documents that are confidential and off limits to pensioners and others interested in seeing them.

Maintaining confidentiality in private equity agreements is imperative, said Christopher W. Ullman, a Carlyle spokesman. In a statement, he said

disclosure “would cause substantial competitive harm.” He added: “These are voluntarily negotiated agreements between sophisticated investors advised by skilled legal counsel. The agreements and other relevant information about the funds are available to federal regulators and auditors.”

Mr. Ullman declined to discuss why Carlyle’s fund investors were being charged for the settlement. But at least one pension fund supervisor is unhappy about the requirement that municipal employees and retirees pay part of that settlement cost.

“This is an overreach on Carlyle’s part, and frankly it violates the spirit of the indemnification clause of our contract,” said Scott M. Stringer, the New York City comptroller, who oversees the three city pension funds involved in the Carlyle deal. Mr. Stringer was not comptroller when the Carlyle investment was made.

Private equity firms now manage \$3.5 trillion in assets. The firms overseeing these funds borrow money or raise it from investors to buy troubled or inefficient companies. Then they try to turn the companies around and sell at a profit.

For much of the last decade, private equity funds have been a great investment. For the 10 years ended in March 2014, private equity generated returns of 17.3 percent, annualized, according to Preqin, an alternative-investment research firm. That compares with 7.4 percent for the Standard & Poor’s 500-stock index.

More recently, however, a simple investment in the broad stock market trounced private equity. For the five years through March, for example, private equity funds returned 14.7 percent, annualized, compared with 21.2 percent for the S.&P. 500. One-year and three-year returns in private equity have also lagged.

Nonetheless, pension funds have jumped into these investments. Last year, 10 percent of public pension fund assets, or \$260 billion, was invested in private equity, according to Cliffwater, a research firm. That was up from \$241 billion in 2012.

But the terms of these deals — including what investors pay to participate in them — are hidden from view despite open-records laws requiring transparency from state governments, including the agencies that supervise public pensions.

Private equity giants like the Blackstone Group, TPG and Carlyle say that divulging the details of their agreements with investors would reveal trade secrets. Pension funds also refuse to disclose these documents, saying that if they were to release them, private equity firms would bar them from future investment opportunities.

The California Public Employees' Retirement System, known as Calpers, is the nation's largest pension fund, with \$300 billion in assets. In a statement, Calpers said it "accepts the confidentiality requirements of limited partnership agreements to facilitate investments with private equity general partners, who otherwise may not be willing to do business with Calpers."

But critics say that without full disclosure, it's impossible to know the true costs and risks of the investments.

"Hundreds of billions of public pension dollars have essentially been moved into secrecy accounts," said Edward A.H. Siedle, a former lawyer for the Securities and Exchange Commission who, through his Benchmark Financial Services firm in Ocean Ridge, Fla., investigates money managers. "These documents are basically legal boilerplate, but it's very damning legal boilerplate that sums up the fact that they are the highest-risk, highest-fee products ever devised by Wall Street."

Retirees whose pension funds invest in private equity funds are being harmed by this secrecy, Mr. Siedle said. By keeping these agreements under wraps, pensioners cannot know some important facts — for example, that a private equity firm may not always operate as a fiduciary on their behalf. Also hidden is the full panoply of fees that investors are actually paying as well as the terms dictating how much they are to receive after a fund closes down.

A full airing of private equity agreements and their effects on pensioners is past due, some state officials contend. The urgency increased this year, these officials say, after the S.E.C. began speaking out about improper practices and fees it had uncovered at many private equity firms.

One state official who has called for more transparency in private equity arrangements is Nathan A. Baskerville, a Democratic state representative from Vance County, N.C., in the north-central part of the state. In the spring, he supported a bipartisan bill that would have required Janet Cowell, the North Carolina state treasurer, to disclose all fees and relevant documents involving the state's private equity investments. The \$90 billion Teachers' and

State Employees' Retirement System pension has almost 6 percent of its funds in private equity deals.

The transparency bill did not pass the General Assembly before it adjourned for the summer. Mr. Baskerville says he intends to revive the bill early next year.

"Fees are not trade secrets," he said. "It's entirely reasonable for us to know what we're paying."

### **Reams of Redactions**

It might help investors to know the fees they are paying, but when it comes to private equity, it's hard to find out.

Consider the Teachers' Retirement System of Louisiana, which holds the retirement savings of 160,000 teachers and retirees. It invested in a buyout fund called Carlyle Partners V, which was Carlyle's biggest domestic offering ever, raising \$13.7 billion in 2007. Companies acquired by its managers included HCR ManorCare, a nursing home operator; Beats Electronics, the headphone maker that was recently sold to Apple for \$3 billion; and Getty Images, a photo and video archive.

Earlier this year, The New York Times made an open-records request to that pension system for a copy of the limited partnership agreement with the Carlyle fund. In response, the pension sent a heavily redacted document — 108 of its 141 pages were either entirely or mostly blacked out. Carlyle ordered the redactions, according to Lisa Honore, the pension's public information director.

The Times also obtained an unredacted version of the Carlyle V partnership agreement. Comparing the two documents brings into focus what private equity firms are keeping from public view.

Many of the blacked-out sections cover banalities that could hardly be considered trade secrets. The document redacted the dates of the fund's fiscal year (the calendar year starting when the deal closed), when investors must pay the management fee to the fund's operators (each Jan. 1 and July 1), and the name of the fund's counsel (Simpson Thacher & Bartlett).

But other redactions go to the heart of the fund's economics. They include all the fees investors pay to participate in the fund, as well as how much they will receive over all from the investment. The terms of that second provision, known as a clawback, determine how much money investors will get after the fund is wound down.

In the Louisiana pension fund's version of the partnership agreement, that section was blacked out. But the clean copy discloses an important provision reducing the amount to be paid to investors.

In order to calculate their total investment returns generated by private equity deals, outside investors must wait until all the companies held in these portfolios have been sold. Any profits above and beyond the 20 percent taken by the general partners overseeing the private equity firms are considered excess gains and are supposed to be returned to investors.

But the Carlyle agreement includes language stating that general partners must return to investors only the *after-tax* amount of any excess gains. Assuming a 40 percent tax rate, this means that if general partners in the fund each received \$2 million in excess distributions, they would have to repay the investors only \$1.2 million each. That's bad news for the funds' investors: They would lose out on \$800,000 in repayments for each partner.

Mr. Ullman of Carlyle declined to comment on this provision.

Also blacked out in the Carlyle V agreement is a section on who will pay legal costs associated with fund operations. First on the hook are companies bought by the fund and held in its portfolio, the unredacted agreement says. That essentially makes investors pay, because money taken from portfolio companies is ultimately extracted from the funds' investors.

But if for some reason those portfolio companies cannot pay, the Carlyle V document says, investors will be asked to cover the remaining expenses. This may require an investor to return money already received — such as excess returns — after a fund has closed, the agreement explains. One way or another, the general partners are protected — and the fund investors, who included tens of thousands of retirees, are responsible for paying the bill. (By contrast, in mutual funds, which are required to make public disclosures and have independent directors, investors are far less likely to be stuck with such costs.)

The Ohio Public Employees Retirement System holds \$150 million in investments in each of the Carlyle IV and V funds. Asked about the requirement to pay the legal settlement costs, a spokesman, Michael Pramik, said he understood why such a question would be raised, but declined to comment.

Another blacked-out section in the Carlyle V agreement dictates how an investor, like a pension fund, also known as a limited partner, should respond

to open-records requests about the fund. The clean version of the agreement strongly encourages fund investors to oppose such requests unless approved by the general partner.

Some pension funds have followed these instructions from private equity funds, even in states like Texas, which have sunshine laws that say “all government information is presumed to be available to the public.”

In mid-September, after receiving an information request about a private equity investment, the Fort Worth Employees’ Retirement Fund denied the request. Doreen McGookey, its general counsel, also sent a letter to the buyout firm, Wynnchurch Capital, based near Chicago, notifying it of the request and instructing Wynnchurch how to deny it by writing to the Texas attorney general, according to a document obtained by The Times.

“If you wish to claim that the requested information is protected proprietary or trade secret information, then your private equity fund must send a brief to the A.G. explaining why the information constitutes proprietary information,” Ms. McGookey’s letter states, adding that the pension “cannot argue this exception on your behalf.” Then the letter warned the private equity firm that if it decided not to submit a brief to the attorney general, that office “will presume that you have no proprietary interest or trade secret information” at stake.

In an email, Ms. McGookey said Texas law required her to notify the private equity firm of the information request.

The Fort Worth pension is not alone in opposing open-records requests for private equity documents. Calpers has also done so. A big investor in private equity, with more than 10 percent of its assets held in such deals, it has put \$300 million into the Carlyle IV fund — the fund that is levying investors for the \$115 million legal settlement reached by Carlyle executives.

Earlier this year, Susan Webber, who publishes the Naked Capitalism financial website under the pseudonym Yves Smith, asked Calpers for data on the fund’s private equity returns. After a legal skirmish, Calpers said last week that it had fulfilled her request. But on Friday, Ms. Webber said Calpers had provided only a small fraction of the data.

Karl Olson is a partner at Ram Olson Cereghino & Kopczynski and the leading lawyer handling Freedom of Information Act litigation in California. He has sued Calpers several times, including a successful suit for the

California First Amendment Coalition, in 2009, forcing Calpers to disclose fees paid to hedge fund, venture capital and private equity managers.

“I think it is unseemly and counterintuitive that these state officials who have billions of dollars to invest don’t drive a harder bargain with the private equity folks,” he said. “A lot of pension funds have the attitude that they are lucky to be able to give their money to these folks, which strikes me as bizarre and certainly not acting as prudent stewards of the public’s money.”

### **‘Not Open and Transparent’**

Regulations require that registered investment advisers put their clients’ interests ahead of their own and that they operate under what is also known as a fiduciary duty. This protects investors from potential conflicts of interest and self-dealing by those managers. This is true of mutual funds, which are also required to make public disclosures detailing their practices.

But, as a lawsuit against Kohlberg Kravis Roberts shows, private equity managers can try to exempt themselves from operating as a fiduciary.

The case involves Christ Church Cathedral of Indianapolis, which contends that it lost \$13 million, or 37 percent, of its endowment because of inappropriate and risky investments, including holdings in hedge funds and private equity deals. The church sued JPMorgan Chase, its former financial adviser, for recommending those investments.

JPMorgan Chase said in a statement that despite market turmoil, “Christ Church’s overall portfolio had a positive return for 2008-2013, the time period covered by the complaint.”

Christ Church’s private equity foray included a small interest in K.K.R. North America Fund XI, a 2012 offering that raised around \$6 billion. K.K.R., the fund’s general partner, can “reduce or eliminate the duties, including fiduciary duties to the fund and the limited partners to which the general partner would otherwise be subject,” the fund’s limited partnership agreement says. Eliminating the general partner’s fiduciary duty to investors in the private equity fund limits remedies available to the church if a breach of fiduciary duty should occur, the church’s lawsuit said.

Kristi Huller, a spokeswoman for K.K.R., initially denied that it could reduce or eliminate its fiduciary duties. But after being presented with an excerpt from the agreement, she acknowledged that its language allowed “a modification of our fiduciary duties.”

Linda L. Pence, a partner at Pence Hensel, a law firm in Indianapolis, represents the church's endowment in the suit. She said she had been shocked by the secrecy surrounding some of her clients' investments. "On one hand they say they don't owe you the duty," she said, "but everything is so confidential with these investments that without a court order, you don't have any idea what they're doing. It's not open and transparent, and that's the kind of structure to me that's ripe for abuse."

Some investors who are privy to the confidential agreements have walked away from these deals. A recent survey of institutional investors by Preqin, the research firm, found that 61 percent indicated that they had turned down a private equity investment because of unfavorable terms.

"It is apparent that private equity fund managers are not doing enough to appease their institutional backers with regards to the fees they charge," Preqin said.

A version of this article appears in print on October 19, 2014, on page BU1 of the New York edition with the headline: Behind Private Equity's Curtain.

## NEWS RELEASE 03/02/15

### **GASB ISSUES FINAL STATEMENT ON FAIR VALUE MEASUREMENT AND APPLICATION**

**Norwalk, CT, March 2, 2015**—The Governmental Accounting Standards Board (GASB) has issued final guidance on accounting and financial reporting issues related to fair value measurements, which primarily applies to investments made by state and local governments.

GASB Statement No. 72, *Fair Value Measurement and Application*, defines fair value and describes how fair value should be measured, what assets and liabilities should be measured at fair value, and what information about fair value should be disclosed in the notes to the financial statements.

Under the new Statement, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Investments, which generally are measured at fair value, are defined as a security or other asset that governments hold primarily for the purpose of income or profit and the present service capacity of which are based solely on their ability to generate cash or to be sold to generate cash.

“The Board’s new guidance responds to stakeholder requests for greater clarity regarding the fair value standards and for improved consistency and comparability in governments’ fair value measurements and disclosures,” said GASB Chairman David A. Vaudt. “The Board believes that requiring governments to provide additional information about how they measure the fair value of their assets and liabilities will increase financial statement users’ understanding of the nature of the fair value information they receive and enhance users’ ability to make decisions with that information.”

Prior to the issuance of Statement 72, state and local governments have been required to disclose how they arrived at their measures of fair value if not based on quoted market prices. Under the new guidance, those disclosures have been expanded to categorize fair values according to their relative reliability and to describe positions held in many alternative investments.

The [full text of Statement 72](#) on fair value and a [GASB In Focus](#) on fair value are available on the GASB website, [www.gasb.org](http://www.gasb.org).

NO. 347 | FEBRUARY 2015

# Governmental Accounting Standards Series

Statement No. 72 of the  
Governmental Accounting  
Standards Board

Fair Value Measurement  
and Application



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## Summary

This Statement addresses accounting and financial reporting issues related to fair value measurements. The definition of *fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This Statement provides guidance for determining a fair value measurement for financial reporting purposes. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements.

## Fair Value Measurement

Fair value is described as an exit price. Fair value measurements assume a transaction takes place in a government's principal market, or a government's most advantageous market in the absence of a principal market. The fair value also should be measured assuming that general market participants would act in their economic best interest. Fair value should not be adjusted for transaction costs.

To determine a fair value measurement, a government should consider the unit of account of the asset or liability. The unit of account refers to the level at which an asset or a liability is aggregated or disaggregated for measurement, recognition, or disclosure purposes as provided by the accounting standards. For example, the unit of account for investments held in a brokerage account is each individual security, whereas the unit of account for an investment in a mutual fund is each share in the mutual fund held by a government.

This Statement requires a government to use valuation techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value. The techniques should be consistent with one or more of the following approaches: the market approach, the cost approach, or the income approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities. The cost approach reflects the amount that would be required to replace the present service capacity of an asset. The income approach converts future amounts (such as cash flows or income and expenses) to a single current (discounted) amount. Valuation techniques should be applied consistently, though a change may be appropriate in certain circumstances. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

This Statement establishes a hierarchy of inputs to valuation techniques used to measure fair value. That hierarchy has three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are inputs—other than quoted prices—included within Level 1 that are observable for the asset or liability, either directly or indirectly. Finally, Level 3 inputs are unobservable inputs, such as management's assumption of the default rate among underlying mortgages of a mortgage-backed security.

A fair value measurement takes into account the highest and best use for a nonfinancial asset. A fair value measurement of a liability assumes that the liability would be transferred to a market participant and not settled with the counterparty. In the absence of a quoted price for the transfer of an identical or similar liability and if another party holds an identical item as an asset, a government should be able to use the fair value of that asset to measure the fair value of the liability.

This Statement requires additional analysis of fair value if the volume or level of activity for an asset or liability has significantly decreased. It also requires identification of transactions that are not orderly. Quoted prices provided by third parties are permitted, as long as a government determines that those quoted prices are developed in accordance with the provisions of this Statement.

## **Fair Value Application**

This Statement generally requires investments to be measured at fair value. An *investment* is defined as a security or other asset that (a) a government holds primarily for the purpose of income or profit and (b) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash. Investments not measured at fair value continue to include, for example, money market investments, 2a7-like external investment pools, investments in life insurance contracts, common stock meeting the criteria for applying the equity method, unallocated insurance contracts, and synthetic guaranteed investment contracts. A government is permitted in certain circumstances to establish the fair value of an investment that does not have a readily determinable fair value by using the net asset value per share (or its equivalent) of the investment.

This Statement requires measurement at acquisition value (an entry price) for donated capital assets, donated works of art, historical treasures, and similar assets and capital assets received in a service concession arrangement. These assets were previously required to be measured at fair value.

## **Fair Value Disclosures**

This Statement requires disclosures to be made about fair value measurements, the level of fair value hierarchy, and valuation techniques. Governments should organize these disclosures by type of asset or liability reported at fair value. It also requires additional disclosures regarding investments in certain entities that calculate net asset value per share (or its equivalent).

## **Effective Date**

The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015. Earlier application is encouraged.

## **How the Changes in This Statement Improve Financial Reporting**

The requirements of this Statement will enhance comparability of financial statements among governments by requiring measurement of certain assets and liabilities at fair value using a consistent and more detailed definition of fair value and accepted valuation techniques. This Statement also will enhance fair value application guidance and related disclosures in order to provide information to financial statement users about the impact of fair value measurements on a government's financial position.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 3 discusses the applicability of this Statement.

## Internal Audit Staff Quarterly Accomplishments

- Karen Morris, Lih-Jen Lan, and Dorvin Handrick attended a 3-day State Auditor's Office training on securing and auditing Microsoft servers and networking infrastructure including Active Directory.
- Hugh Ohn and Nick Ballard attended the Annual Emerging Manager Conference in January.
- Internal Audit is once again hosting three students from the University of Texas at Austin who are working on a consulting project for their graduate audit class project. Dinah Arce is project lead. The students will be assisting Human Resources in identifying best practices related to retaining top performing employees and managers.
- Internal Audit hired Cody Conrado as a part-time intern for the 2015 Spring Semester. Cody is attending Texas State University, majoring in Finance. He is serving as Treasurer for the University's Student Managed Investment Fund (SMIF). Cody is assisting Hugh Ohn and Nick Ballard in completing the investment controls and compliance projects.
- Hugh Ohn graduated from the 2014 TRS Leadership Development Program, a seven month program. He is one of the nine graduates from the program.