



**John Keel, CPA**  
**State Auditor**

An Audit Report on

**Ethics Policies for Trustee  
Investing Practices at  
the Employees Retirement  
System, the Teacher Retirement  
System, and The University of  
Texas Investment Management  
Company**

April 2009

Report No. 09-031



An Audit Report on

# *Ethics Policies for Trustee Investing Practices at the Employees Retirement System, the Teacher Retirement System, and The University of Texas Investment Management Company*

SAO Report No. 09-031  
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## *Overall Conclusion*

Ethics policies for investment practices at the Employees Retirement System (ERS), the Teacher Retirement System (TRS), and The University of Texas Investment Management Company (UTIMCO) comply with statutory requirements.

Opportunities exist for all three entities to strengthen the processes through which board members, employees, and contractors disclose information regarding potential conflicts of interest. Additionally, all three entities should strengthen their processes for authorizing and monitoring employees' personal securities transactions and better safeguard confidential investment information.

ERS, TRS, and UTIMCO also should enhance their emphasis on ethics by consistently providing ethics training to board members and employees, strengthening their criminal background checks, and implementing or strengthening processes for employees to report ethics violations anonymously.

Results of a State Auditor's Office survey of employees covered by investment ethics policies at ERS, TRS, and UTIMCO indicated that most employees surveyed believed their entities have high ethical standards. For example, 94 percent of all survey respondents were confident that any ethics violations they report will be appropriately processed and resolved. However, survey respondents' comments indicate that the entities do not provide sufficient training on their ethics policies.

### Background Information

#### Employees Retirement System (ERS):

- **Summary:** ERS oversees retirement benefits for 135,171 State of Texas employees and 73,266 retirees.
- **Board:** Three ERS board members are appointed (one each by the Governor, the Speaker of the House, and the Chief Justice of the Texas Supreme Court), and three board members are elected by members and retirees.
- **Fund Value:** Approximately \$16.7 billion as of January 2009.

#### Teacher Retirement System (TRS):

- **Summary:** TRS oversees retirement benefits for more than 966,000 active teachers and higher education employees and more than 275,000 retirees.
- **Board:** The TRS board includes nine trustees who are appointed by the governor to staggered, six-year terms.
- **Fund Value:** Approximately \$75.8 billion as of January 2009.

#### The University of Texas Investment Management Company (UTIMCO):

- **Summary:** UTIMCO manages investments for the University of Texas System and the Texas A&M University System. It is a 501(c)(3) corporation.
- **Board:** The UTIMCO board, which is appointed by the University of Texas System Board of Regents, includes three University of Texas System regents, the Chancellor of the University of Texas System, and five outside directors with experience in investment management (one of these five outside directors is a member of the Texas A&M University System Board of Regents).
- **Fund Value:** Approximately \$18 billion as of January 2009.

This audit was conducted in accordance with Texas Government Code, Section 321.0132.

For more information regarding this report, please contact Anita D'Souza, General Counsel, or John Keel, State Auditor, at (512) 936-9500.

## ***Summary of Management's Response***

The responses that ERS, TRS, and UTIMCO management provided addressed the recommendations in this report and, in some cases, provided additional details. Detailed management's responses are presented in Appendix 4 on page 27.

## ***Summary of Information Technology Review***

The information technology component of this audit focused on determining whether authorized individuals at ERS, TRS, and UTIMCO had access to the Bloomberg Portfolio Order Management System (Bloomberg System), which contains restricted investment data. ERS, TRS, and UTIMCO use the Bloomberg System as their primary source of real-time and historical financial information to help them make decisions and execute stock and other equities trades. The Bloomberg System allows the entities to monitor their investment portfolios on a real-time basis. None of the board members of ERS, TRS, or UTIMCO has access to the entities' trading information.

Although access controls at all three entities were generally working as intended, auditors identified the following weaknesses:

- Individuals at ERS and TRS who are not covered by the ethics policies have access to Bloomberg System information. These individuals should be required to comply with the ethics policies.
- Multiple users in the TRS investment section have system administrator access to the Bloomberg System. With system administrator access, individuals can control other users' access permissions to the Bloomberg system. System administrator access should be limited to one to two employees who are responsible for user access and for providing users with user account permissions.
- Multiple UTIMCO users with system administrator access to the Bloomberg System share the same user account. This prevents the creation of an audit trail to identify who accesses that account.

See Chapter 2-D of this report for additional information about the above issues.

## ***Summary of Objectives, Scope, and Methodology***

The objectives of this audit were to:

- Determine whether the ethics policies for trustee investing practices of ERS, TRS, and UTIMCO (investing entities) are consistent with applicable statutory requirements.

- Determine whether controls designed to help ensure compliance with ethics policies at the investing entities are working as intended.

The audit scope covered ERS, TRS, and UTIMCO ethics policies and processes and controls related to ethics policies between September 1, 2005, and December 31, 2008.

The audit methodology included reviewing each entity's ethics policies and interviewing staff and board members. Auditors reviewed processes at ERS, TRS, and UTIMCO that are designed to ensure compliance with ethics policies. Auditors tested ethics compliance documentation to assess the entities' effectiveness in detecting and preventing conflicts of interest.

# Contents

## *Detailed Results*

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Chapter 1	Ethics Policies at ERS, TRS, and UTIMCO Comply with Statutory Requirements .....	1
Chapter 2	ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying Potential Conflicts of Interest, Monitoring Employees' Personal Securities Trades, and Safeguarding Confidential Investment Information .....	4
Chapter 3	ERS, TRS, and UTIMCO Should Provide Regular Ethics Training, Strengthen Their Criminal Background Checks, and Implement or Strengthen Processes for Employees to Report Ethics Violations Anonymously .....	16

## *Appendices*

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Appendix 1	Objectives, Scope, and Methodology .....	19
Appendix 2	Example of the Resolution of a Conflict of Interest Discussed at a Board Meeting .....	23
Appendix 3	Survey Results .....	25
Appendix 4	Management's Responses .....	27
Appendix 5	Recent State Auditor's Office Reports .....	45

# Detailed Results

Chapter 1

## *Ethics Policies at ERS, TRS, and UTIMCO Comply with Statutory Requirements*

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Ethics policies at the Employees Retirement System (ERS), the Teacher Retirement System (TRS), and The University of Texas Investment Management Company (UTIMCO) comply with statutory requirements.<sup>1</sup> The statutes that are the basis for ERS, TRS, and UTIMCO ethics policies primarily address:

- The adoption of ethics policies.
- Financial disclosure statement requirements for board members and executive directors.
- Conflict of interest disclosure requirements for board members, employees, and contracted advisors and service providers.
- Monitoring of employees' personal securities transactions.

UTIMCO has fewer statutory requirements for its ethics policy than ERS or TRS, but its ethics policy addresses similar issues as the ethics policies at ERS and TRS. In addition, statutory requirements differ for each entity in certain areas. For example:

- Statutory requirements regarding coinvestment. Texas Government Code, Chapter 572, prohibits a state officer<sup>2</sup> or employee at ERS and TRS from having interests that are “in substantial conflict with the officer’s or employee’s duties in the public interest.” This statute covers situations in which the officer or employee owns more than a 10 percent voting interest or more than a 10 percent interest in the profits of a business in which the state agency also has invested. Texas Education Code, Chapter 66, prohibits UTIMCO from investing in a business when a board member or employee has a 5 percent or greater interest in the business.
- Statutory requirements regarding financial disclosure statements. Texas Government Code, Chapter 572, requires board members and the

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<sup>1</sup> The statutes discussed in this chapter do not comprise a complete list of statutes related to investment practices at the audited entities. This chapter focuses only on statutes that (1) directly relate to ethics policy requirements at ERS, TRS, and UTIMCO and (2) establish ethics-related responsibilities of board members, employees, and contractors of these entities.

<sup>2</sup> At ERS and TRS, state officers include board members and executive directors.

executive directors at ERS and TRS to file annual financial disclosure statements with the Texas Ethics Commission. There are no statutory requirements for UTIMCO board members to file annual financial disclosure statements. However, four of the nine UTIMCO board members are required to submit annual financial disclosure statements in their capacity as members of university system boards of regents; one of the nine UTIMCO board members is required to submit an annual financial disclosure statement in his capacity as chancellor of the University of Texas System.

Table 1 summarizes the statutory requirements.

Table 1

Summary of Statutory Requirements for Ethics Policies at ERS, TRS, and UTIMCO		
ERS	TRS	UTIMCO
<b>Adoption of Ethics Policies</b>		
<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapter 815, requires the ERS board of trustees to adopt an investment policy that includes a code of ethics. The code must contain standards of conduct and disclosure requirements.</li> <li>▪ Texas Government Code, Chapter 572, requires state agencies (including ERS) to adopt a written ethics policy that includes basic standards of conduct and prohibitions addressing (1) the acceptance of gifts, (2) outside employment, and (3) personal investments that could create conflicts of interest.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapter 825, requires the TRS board of trustees to enforce an ethics policy. Statute requires the policy to cover (1) personal financial holding and outside employment disclosure requirements and (2) standards of conduct for consultants and advisors.</li> <li>▪ Texas Government Code, Chapter 572, requires state agencies (including TRS) to adopt a written ethics policy that includes basic standards of conduct and prohibitions addressing (1) the acceptance of gifts, (2) outside employment, and (3) personal investments that could create conflicts of interest.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Texas Education Code, Section 66.08, requires the University of Texas System Board of Regents to approve the ethics policy of UTIMCO; statute does not provide any additional requirements in this area.</li> </ul>
<b>Financial Disclosure Statements</b>		
<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapter 572, requires the ERS board of trustees and ERS executive director to submit annual financial disclosure statements to the Texas Ethics Commission.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapter 572, requires the TRS board of trustees and TRS executive director to submit annual financial disclosure statements to the Texas Ethics Commission.</li> <li>▪ Texas Government Code, Chapter 825, requires TRS employees who exercise significant decision-making authority or who have fiduciary authority to submit annual financial disclosure statements to a person designated by the board of trustees in accordance with Texas Government Code, Chapter 572.</li> </ul>	<ul style="list-style-type: none"> <li>▪ UTIMCO is not subject to Texas Government Code, Chapter 572, but UTIMCO requires its board of directors and its employees to submit annual financial disclosure statements internally. Additionally, four of the nine UTIMCO board members are required to submit annual financial disclosure statements to the Texas Ethics Commission in their capacity as members of university system boards of regents, and one of the nine UTIMCO board members is required to submit an annual financial disclosure statement in his capacity as chancellor of the University of Texas System.</li> </ul>

**Summary of Statutory Requirements for Ethics Policies at ERS, TRS, and UTIMCO**

ERS	TRS	UTIMCO
<b>Conflict of Interest Disclosure</b>		
<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapter 572, requires the trustees of state agencies (including ERS) to disclose publicly any personal or private interests in matters before the board. The trustee may not vote or participate in the decision, and the disclosure shall be included in board meeting minutes.</li> <li>▪ Texas Government Code, Chapter 572, allows co-investment in a business only when an employee or board member owns less than 10 percent of the voting interest; less than \$25,000 of the fair market value; or has an interest in less than 10 percent of the profits, proceeds, or capital gains of the business.</li> <li>▪ Texas Government Code, Chapter 2263, requires the financial advisors and service providers of state entities (including ERS) to file annual conflict of interest disclosure statements. The statements must include a description of any relationships to or interests with parties to a transaction with the state entity.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapter 572, requires the trustees of state agencies (including TRS) to disclose publicly any personal or private interests in matters before the board. The trustee may not vote or participate in the decision, and the disclosure shall be included in board meeting minutes.</li> <li>▪ Texas Government Code, Chapter 572, allows co-investment in a business only when an employee or board member owns less than 10 percent of the voting interest; less than \$25,000 of the fair market value; or has an interest in less than 10 percent of the profits, proceeds, or capital gains of the business.</li> <li>▪ Texas Government Code, Chapter 2263, requires the financial advisors and service providers of state entities (including TRS) to file annual conflict of interest disclosure statements. The statements must include a description of any relationships to or interests with parties to a transaction with the state entity.</li> <li>▪ Texas Government Code, Chapter 825, requires TRS employees to disclose any relationships that might diminish the employees' independence and requires such employees to refrain from giving advice unless the board, in consultation with the general counsel, waives the conflict.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Although UTIMCO includes conflict of interest disclosure requirements in its ethics policy, there is no statutory requirement for this.</li> <li>▪ Texas Education Code, Section 66.08, prohibits UTIMCO from investing in a business in which a director or employee owns 5 percent of the voting stock or shares, owns 5 percent of the fair market value, or received 5 percent of his or her income in the previous year from the business.</li> <li>▪ Texas Government Code, Chapter 2263, requires the financial advisors and service providers of state entities (including UTIMCO) to file annual conflict of interest disclosure statements. This statement must include a description of any relationships to or interests with parties to a transaction with the state entity.</li> </ul>
<b>Monitoring of Employees' Personal Securities Transactions</b>		
<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapters 572 and 815, prohibit trustees and employees of ERS from having an interest in or gaining personal profits from investments by ERS. Although these prohibitions do not outline specific controls, they provide the statutory basis for ERS's policies on monitoring employees' personal securities transactions.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Texas Government Code, Chapters 572 and 825, prohibit trustees and employees at TRS from having an interest in or gaining personal profits from investments by TRS. Although these prohibitions do not outline specific controls, they provide the statutory basis for TRS's policies on monitoring employees' personal securities transactions.</li> </ul>	<ul style="list-style-type: none"> <li>▪ UTIMCO does not have a statutory requirement that serves as the basis for monitoring personal securities transactions, but its ethics policy includes monitoring provisions similar to monitoring provisions in the ethics policies of ERS and TRS.</li> </ul>

## ***ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying Potential Conflicts of Interest, Monitoring Employees' Personal Securities Trades, and Safeguarding Confidential Investment Information***

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ERS, TRS, and UTIMCO rely on self-disclosed information from board members, employees, and contractors to identify and resolve conflicts of interest. The entities also rely on employees to self-disclose personal security trades, obtain pre-approval for the trades, and confirm within 10 days whether they executed the trades for which they obtained pre-approval.

While there are few alternatives to the self-disclosure process, ERS, TRS, and UTIMCO should strengthen their ability to identify potential conflicts of interest by (1) better tracking and monitoring the submission of self-disclosed information and (2) regularly using available public information to independently verify the completeness of the information that board members and employees disclose.

ERS, TRS, and UTIMCO also should strengthen their monitoring of employees' personal securities trades and better safeguard confidential investment information.

### Chapter 2-A

## **ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Board Members' Potential Conflicts of Interest**

Identifying and resolving conflicts of interest is a principle issue addressed by the ethics policies at ERS, TRS, and UTIMCO. Currently, all three entities rely on board members to fully disclose conflicts of interest by (1) discussing potential conflicts in public board meetings and (2) filing annual financial disclosure statements. However, none of the entities has a process to independently verify or identify potential conflicts of interest.

### **Board Member Conflict of Interest Disclosures**

Board member conflict of interest disclosures are discussed at ERS, TRS, and UTIMCO board meetings. Auditors reviewed board meeting minutes at ERS, TRS, and UTIMCO for fiscal year 2006 through the first quarter of 2009 and determined that disclosed conflicts of interest involving ERS, TRS, and UTIMCO board members were discussed and resolved at board meetings as required by statute and ethics policies.

According to the board minutes, five discussions of board member conflicts of interest took place at TRS board meetings during this time period. ERS's board meeting minutes indicate that only one potential conflict of interest was

discussed in a board meeting and resolved in a subsequent meeting during this time period. UTIMCO board members have resolved conflicts of interest by abstaining from voting on items for which they perceived they had a potential conflict of interest (see Appendix 2 for an example of a conflict-of-interest resolution at UTIMCO).

Although ERS, TRS, and UTIMCO have processes for discussing disclosed conflicts of interest at board meetings, they do not make use of available public information to independently verify that board members disclose all information regarding potential conflicts of interest. Regularly checking public information sources such as the U.S. Securities and Exchange Commission's Web site and the Texas Secretary of State's Web site would enable the entities to have an additional measure of assurance that potential conflicts of interest will be identified and resolved promptly.

#### Board Member Financial Disclosure Statements

Texas Government Code, Chapter 572, requires ERS and TRS board members to file annual financial disclosure statements with the Texas Ethics Commission. All ERS and TRS board members filed these disclosures in 2007 and 2008, but one ERS board member filed this disclosure one month late.

Texas Government Code, Chapter 572, does not apply to UTIMCO board members, but four of the nine UTIMCO board members are required to file financial disclosure statements with the Texas Ethics Commission in their capacity as members of university system boards of regents. Another UTIMCO board member is required to file an annual financial disclosure statement with the Texas Ethics Commission in his capacity as chancellor of the University of Texas System.<sup>3</sup> These five board members filed their financial disclosure statements in 2007 and 2008. Additionally, UTIMCO requires all members of its board to file annual financial disclosure statements internally, but UTIMCO does not ensure that board members file these statements on time.

ERS and TRS do not track the financial disclosure statements that board members file with the Texas Ethics Commission. UTIMCO uses an electronic spreadsheet to track all required financial disclosure statement filings. Although UTIMCO tracks this information, some board members did not file or update internal financial disclosure statements when they were due. Specifically:

- From fiscal year 2006 through fiscal year 2008, UTIMCO board members did not file 9 (29 percent) of 31 financial disclosure statements by the due

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<sup>3</sup> UTIMCO obtains the financial disclosure statements that its board members file with the Texas Ethics Commission.

date in UTIMCO's policy. On average, these nine disclosures were filed fewer than 30 days after the due date.

- One former UTIMCO board member did not promptly disclose ownership of more than 5 percent of a company, as required by UTIMCO's ethics policy. Because a UTIMCO external investment manager's portfolio already included an ownership interest in this company, that ownership interest represented a conflict of interest. UTIMCO promptly resolved the conflict of interest when staff identified it by requiring the external investment manager to divest itself of its ownership interest in the company.

Requiring all board members to file financial disclosure statements internally and tracking and reviewing financial disclosure statements would enhance the ability of ERS and TRS to identify and resolve potential conflicts of interest. In addition, regularly checking public information, such as the public information available on the U.S. Securities and Exchange Commission's Web site, would help ERS, TRS, and UTIMCO identify potential conflicts of interest.

### Recommendations

ERS, TRS, and UTIMCO should consider regularly reviewing public information to independently verify the completeness of the financial disclosure statements that board members submit.

ERS and TRS should:

- Require board members to simultaneously file copies of their financial disclosure statements with both the Texas Ethics Commission and with the agencies' ethics compliance officer.
- Regularly review board members' financial disclosure statements for potential conflicts of interest.

Chapter 2-B

### **ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Employees' Potential Conflicts of Interest**

ERS, TRS, and UTIMCO should strengthen their processes for identifying and resolving employees' potential conflicts of interest by requiring employees who are involved in investment decisions to annually submit the following:

- Conflict of interest disclosures.

- Financial disclosure statements.
- Outside employment and business activity disclosures.
- Ethics compliance statements.

Additionally, ERS, TRS, and UTIMCO should periodically search publicly available information to verify the completeness of information that employees submit.

#### **Employee Conflict of Interest Disclosures**

While ERS requires employees to disclose conflicts of interest only in specific circumstances, TRS and UTIMCO require written affirmation annually that employees have no conflicts of interest. ERS should strengthen its disclosure process by requiring annual written affirmations that employees have no conflicts of interest.

#### **Employee Financial Disclosure Statements**

ERS and TRS executive directors are statutorily required to file annual financial disclosure statements with the Texas Ethics Commission.<sup>4</sup> The ERS and TRS executive directors filed these disclosures in 2007 and 2008. However, ERS and TRS do not review copies of these financial disclosure statements. Reviewing copies of the statements, along with board member disclosures (as discussed in Chapter 2-A), could enhance the entities' ability to identify potential conflicts of interest.

UTIMCO requires all of its employees to file annual financial disclosure statements internally. TRS requires key employees to file annual financial disclosure statements internally. However, UTIMCO and TRS do not independently verify the completeness of employees' annual financial disclosure statements. ERS does not require any of its employees to file annual financial disclosure statements internally.

Requiring all employees who are involved in investment decisions to file financial disclosure statements internally, as well as tracking, reviewing, and verifying the completeness of the statements of employees and board members (as discussed in Chapter 2-A), would enhance all three entities' ability to identify and address potential conflicts of interest.

#### **Employee Disclosures of Outside Employment and Business Activities**

TRS and UTIMCO require key employees to disclose and obtain approval for outside employment and business activity. Of the three entities, only TRS

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<sup>4</sup> Texas Government Code, Chapter 572, requires state agency executive directors to annually file financial statements with the Texas Ethics Commission.

uses an annual disclosure form for employees to disclose outside employment. ERS and UTIMCO do not use forms for disclosing outside employment and business activity. None of the entities uses publicly available information such as the Texas Secretary of State's Web site to independently identify employees' outside employment and business activities. TRS also requires all employees to sign an ethics compliance statement attesting to whether they have any outside employment or business activity.

UTIMCO does not require approval for outside employment that existed before key UTIMCO employees began employment at UTIMCO. To strengthen its ability to identify conflicts of interest, UTIMCO should require all employees to disclose and obtain approval for outside employment on an annual basis. This could be accomplished by requiring employees to disclose outside employment or business activities, or affirm that they have none, on the employees' annual financial disclosure statements.

#### Employee Ethics Compliance Statements

TRS and UTIMCO require employees to sign an annual statement affirming that they are in compliance with their entity's ethics policy. ERS requires its employees to sign an annual statement that they are in compliance with the code of ethics of the Chartered Financial Analyst Institute (CFAI). To help ensure compliance, ERS should require its employees to annually affirm that they have complied with the ERS ethics policy, which includes specific procedures that the CFAI code of ethics does not cover.

#### Recommendations

ERS, TRS, and UTIMCO ethics compliance officers should consider regularly reviewing public information to independently verify the completeness of the information that employees disclose.

ERS and UTIMCO should require all employees covered by their investment ethics policies to sign annual statements affirming that they have disclosed and received approval for any outside employment or business activities.

ERS and TRS should:

- Require executive directors to file financial disclosure statements with the agencies' ethics compliance officers at the same time that the executive directors submit these statements to the Texas Ethics Commission.
- Require all employees who are involved in investment decisions to file financial disclosure statements internally.

ERS should:

- Require employees to annually affirm that they are in compliance with the ERS ethics policy.
- Require employees to sign annual affirmations that they have no conflicts of interest.

Chapter 2-C

## ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Contractors' Potential Conflicts of Interest

### Financial Advisors and Service Providers

The Texas Government Code specifies that a financial advisor or service provider is "a person or business entity who acts as a financial advisor, financial consultant, money or investment manager, or broker."

Source: Texas Government Code, Section 2263.002.

ERS, TRS, and UTIMCO use contracted financial advisors and service providers to assist their investment staff to manage the entities' funds. Therefore, it is important to ensure that contracted financial advisors and service providers are free from conflicts of interest that might interfere with the entities' fiduciary responsibilities.

TRS and UTIMCO should strengthen their processes to ensure that contracted financial advisors and service providers comply with statutory requirements<sup>5</sup> to annually disclose conflicts of interest.

### Contractor Conflict of Interest Disclosures

Auditors obtained lists of contracted financial advisors and service providers from ERS, TRS, and UTIMCO to determine (1) whether financial advisors and service providers complied with statutory requirements to file annual conflict of interest disclosure statements and (2) whether the entities' processes for tracking compliance were adequate. Auditors reviewed conflict of interest disclosure statements filed at ERS and TRS in calendar years 2007 and 2008<sup>6</sup> and found the following:

- At TRS, of the 54 required disclosures from financial advisors and service providers that auditors tested, 3 (5.6 percent) did not file annual conflict of interest disclosure statements with TRS.
- At ERS, all of the required disclosures from financial advisors and service providers that auditors tested were filed with ERS, as required by statute.

<sup>5</sup> Texas Government Code, Chapter 2263, requires any individual who receives more than \$10,000 in compensation from a state governmental entity for providing financial services or financial advisement to file an annual conflict of interest disclosure statement with the governmental entity and with the State Auditor's Office.

<sup>6</sup> Texas Government Code, Chapter 2263, requires financial advisors and service providers to submit annual conflict of interest disclosure statements by April 15.

In 2007, UTIMCO determined that 11 (6.4 percent) of 173 financial advisors and service providers did not file conflict of interest disclosure statements as required by statute. In 2008, UTIMCO determined that 10 (4.8 percent) of 209 financial advisors and service providers did not file these statements. While UTIMCO maintains spreadsheets to track the submission of these statements, 12 service providers were not listed on any of these tracking spreadsheets. As a result, UTIMCO could not provide reasonable assurance that the tracking spreadsheets were complete.

Not obtaining these disclosures in a timely manner may prevent the entities from identifying potential conflicts of interest that could affect investment decisions.

TRS and UTIMCO tracking of financial advisors and service providers. TRS and UTIMCO should improve their processes for ensuring that they inform all contracted financial advisors and service providers about their responsibility to comply with statutory conflict of interest disclosure requirements. For example, although UTIMCO has a process for tracking financial advisors' and service providers' submission of annual conflict of interest disclosures, UTIMCO did not request a disclosure from 12 brokers that it used in calendar year 2007 because it mistakenly excluded them from its list of contracted financial advisors and service providers.

UTIMCO also distributes a list of securities owned by board members and employees to external investment managers to prevent the managers from purchasing the securities and creating a conflict of interest. However, on one occasion, UTIMCO did not follow its procedures in this area. In this case, UTIMCO did not distribute the list of restricted securities to an external investment manager, and the external manager purchased a security that was on the restricted list. This resulted in a conflict of interest. UTIMCO identified the problem through a routine report it generates that identifies any transactions made that involve restricted securities. UTIMCO immediately instructed the external investment manager to sell UTIMCO's shares in the restricted security.

Non-employees working in the TRS investment division. Several individuals who are not TRS employees work in the TRS investment division. State Street Corporation, through its contract for securities lending services with TRS, pays these individuals' wages; however, these individuals do not have a documented contractual relationship with State Street Corporation. These individuals are not covered by State Street Corporation's contractual obligations, and they are not required to comply with TRS's investment ethics policy.<sup>7</sup> Consequently, these individuals are not required to disclose any

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<sup>7</sup> TRS requires these individuals to comply with its personal security trade policy by obtaining TRS's approval for and disclosing all personal security trades.

potential conflicts of interest that may arise as a result of their work at TRS. It is important that TRS ensure these individuals receive training on and comply with the investment ethics policy at TRS.

#### Vendor-paid Travel and Gifts

Vendor-paid travel. In fiscal year 2008, ERS stopped allowing vendors to pay for ERS employees' travel. TRS processes vendor-paid travel that employees take through its travel coordinator and later seeks reimbursement from the vendor.<sup>8</sup> This control helps to ensure that TRS is aware of all vendor-paid travel. Vendor-paid travel at each entity was as follows:

- ERS provided auditors with documentation related to approximately \$4,600 in vendor-paid travel in fiscal year 2007.
- TRS provided auditors with documentation related to approximately \$17,000 in vendor-paid travel in fiscal year 2007 and approximately \$61,000 in vendor-paid travel in fiscal year 2008.

UTIMCO<sup>9</sup> does not track the amount vendors pay for UTIMCO employees to travel; however, UTIMCO provided auditors with documentation for 27 UTIMCO employee trips during fiscal years 2007 and 2008 for which vendors that conducted business with UTIMCO paid part of the cost.

Gifts and entertainment. TRS tracks the receipt and return of gifts that employees receive. Although ERS's policy requires the return of gifts to employees, ERS does not track the return or disposal of gifts. Although UTIMCO's policy prohibits certain gifts to employees, UTIMCO should create a process to ensure that employees appropriately return or dispose of prohibited gifts.

Auditors identified one entertainment event that UTIMCO did not approve in writing as required. UTIMCO should improve its monitoring in this area by creating a specific place on its travel approval form to list all expenses, including entertainment, that will be paid for by third parties.

#### Recommendations

TRS and UTIMCO should develop procedures to ensure that they notify all financial advisors and service providers of the statutory requirement to file an annual conflict of interest disclosure statement. The entities should track submission of these statements to ensure that all financial advisors and service

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<sup>8</sup> TRS allows vendors to pay directly for employee travel related to its Private Investment Fund Advisory Board.

<sup>9</sup> UTIMCO is not subject to state travel requirements and rates.

providers comply, and they should consider suspending business activities with service providers that do not submit disclosures by the filing due date.

ERS and UTIMCO should consider tracking the receipt and disposal of all prohibited gifts they receive.

UTIMCO should:

- Ensure that it distributes its list of restricted securities to all external investment managers.
- Review and approve vendor-paid entertainment and establish a specific process for employees to request approval.
- Consider including on its travel approval form a list of all expenses, including entertainment expenses, that will be paid for by a third party.

TRS should ensure that all individuals working in the investment division are required to comply with the TRS investment ethics policy.

Chapter 2-D

### **ERS, TRS, and UTIMCO Should Strengthen Processes for Monitoring Employees' Personal Securities Trades and Safeguarding Confidential Investment Information**

ERS, TRS, and UTIMCO should strengthen their processes to ensure that employees do not profit from advanced knowledge of institutional investment decisions. Specifically, the entities should strengthen monitoring of employees' personal securities trades and better safeguard confidential investment information.

#### **Personal Securities Trades**

Monitoring employee personal security trades is challenging because the process is dependent on employee self-disclosure. UTIMCO and TRS require employees to disclose trades within 10 days of the trade, but ERS requires employees to disclose their personal trades only on a quarterly basis. ERS requires employees to obtain approval to trade a security if ERS owns or is about to purchase that security.

In addition to employee self-disclosure, ERS and TRS also require employees to provide confirmations from their brokers for all personal trades they have made.<sup>10</sup> This assists ERS and TRS in ensuring that employees comply with

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<sup>10</sup> TRS began requiring broker confirmations in January 2009. Auditors tested personal security transactions executed prior to January 2009.

the entities' policies on personal trades. UTIMCO does not require employees to provide trade confirmations from their brokers. Additionally, ERS reconciles all personal trade information on a quarterly basis and reports the results to its board.

Auditors noted cases in which one ERS employee and three UTIMCO employees violated personal trading policies on more than one occasion. As of March 2009, ERS was still reviewing the case involving its employee. The UTIMCO employees did not receive written reprimands. TRS does not track verbal warnings administered to employees for minor violations of its ethics policy.

Enforcing penalties could enhance employee compliance with personal trade disclosure requirements. Auditors reviewed instances at UTIMCO, TRS, and ERS in which employees made personal securities trades (1) without obtaining advanced approval, (2) without disclosing the trades within the timeframe required by ethics policies, or (3) outside of the timeframe permitted by policy. Specifically:

- Auditors tested a sample of 30 UTIMCO employee-disclosed personal trades made between September 1, 2005, and December 31, 2008, and determined that employees did not disclose 14 (46.7 percent) of these trades within 10 days of the trade as required. One of these 14 trades was disclosed 333 days after it took place; the remaining 13 trades were disclosed within an average of 37 days. In addition, for 26 of the 30 trades tested, employees were required to obtain approval; however, for 8 (30.8 percent) of those 26 trades, employees did not obtain approval or did not execute the trade on the same day they requested approval. UTIMCO's compliance officer reviewed these trades to ensure they did not result in the employees profiting from advanced knowledge of institutional investment decisions or conflicts of interest.
- Auditors tested a sample of 37 TRS employee-disclosed trades made between July 1, 2007, and December 31, 2008, and determined that employees executed 2 (5.4 percent) of the 37 trades without obtaining required approval. However, it is important to note that the TRS compliance officer also identified this issue. Additionally, for the sample tested, TRS employees fully complied with policies requiring them to disclose the trades within 10 days.
- Auditors tested a sample of 30 ERS employee-disclosed trades made in fiscal years 2006 through 2008 and determined that 1 (3.3 percent) of the 30 trades was executed by an employee on the same date that ERS traded the same security. It is important to note that the ERS investment compliance auditor also identified this issue.

To help facilitate analysis of personal trading information, TRS created a database of employee personal trades. The database includes information such as dates, times, numbers of shares, and ticker symbols of the securities traded. TRS analyzes this information for patterns of personal trades being executed close to when TRS executes trades. ERS and UTIMCO do not keep employees' personal trade information in a format that facilitates analysis.

#### Safeguarding Confidential Trade Information

ERS, TRS, and UTIMCO rely on the Bloomberg Portfolio Order Management System (Bloomberg System) to track trade information. None of the entities allows board member to have access to confidential trade information, and ERS does not allow Investment Advisory Committee members to have access to the Bloomberg System.

The Bloomberg System contains information about the entities' pending trades. There is the potential for employees to use that information for personal gain.<sup>11</sup> Therefore, all three entities should strengthen controls by limiting the access of employees not covered by ethics policies and limiting administrative access rights. Specifically:

- At TRS, a Professional Services Contractor has access to all orders in the Bloomberg System. Additionally, contract employees at TRS have access to a database that stores Bloomberg System trade information, which could allow them to view open order information (TRS recently revised its trading policy to cover certain contractors). TRS also has five system administrator accounts for the Bloomberg System. Each of these issues increases the risk for unauthorized access to the Bloomberg System, and therefore increases the risk that an individual could personally profit by having advanced knowledge of TRS trades.
- At ERS, the investment compliance auditor has access to trading information in the Bloomberg System, which includes access to trade orders that have not been completed. Although the investment compliance auditor has this access, the investment compliance auditor position is not currently required to comply with the ERS investment ethics policy.
- At UTIMCO, four users share the Bloomberg System administrator account, which enables them to provide Bloomberg System access to other employees. Sharing these accounts prevents the creation of an audit trail because it eliminates the ability to record exactly who last used the account.

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<sup>11</sup> Texas Government Code, Chapters 572, 815, and 825, prohibit ERS and TRS trustees and employees from having an interest in or gaining personal profits from investments by the entity.

## Recommendations

ERS, TRS, and UTIMCO should:

- Consider requiring an annual statement from employees, as part of the ethics compliance statement, stating that the employees do not have any undisclosed brokerage accounts and that they have not conducted any undisclosed personal securities trades. The ethics policies should clearly state the penalties for conducting personal securities trades without prior disclosure.
- Consistently enforce penalties for violations of personal trading policies and track verbal warnings given to employees regarding their personal trades.

ERS and UTIMCO should consider tracking employee personal trade disclosure information to facilitate analysis of this information.

TRS and UTIMCO should strengthen access controls by limiting the number of system administrator accounts for the Bloomberg System.

UTIMCO should:

- Consider obtaining independent broker confirmations of employees' personal securities trades.
- Prohibit the use of shared accounts for the Bloomberg System.

ERS should ensure that all employees with access to confidential trade information are required to comply with its investment ethics policy.

TRS should ensure that only individuals who are required to comply with its investment ethics policy have access to confidential trade information.

## ***ERS, TRS, and UTIMCO Should Provide Regular Ethics Training, Strengthen Their Criminal Background Checks, and Implement or Strengthen Processes for Employees to Report Ethics Violations Anonymously***

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Providing regular training and strengthening background checks on job applicants and existing employees can help ERS, TRS, and UTIMCO ensure compliance with their ethics policies. Additionally, the ability to report ethics policy violations anonymously without fear of retaliation can be a valuable control for employees at all three entities.

All three entities should ensure that board members and employees covered by their investment ethics policies receive ethics training on a regular basis. They also should conduct Federal Bureau of Investigation (FBI) criminal background checks for all applicants for jobs covered by their investment ethics policies, as well as for existing employees covered by their investment ethics policies. TRS should develop an anonymous reporting process for employees to report ethics violations, and ERS and UTIMCO should better promote their anonymous reporting processes to their employees.

### **Ethics Training**

TRS does not require regular ethics training for employees covered by its investment ethics policies and the members of its board of trustees. When the State Auditor's Office surveyed employees of ERS, TRS, and UTIMCO, TRS had the lowest percentage of employees who strongly agreed or agreed with the statement "Ethics training within the agency is adequate and helps me understand what is expected of me as an employee."<sup>12</sup> (See Appendix 3 for additional survey details.) A lack of adequate training for employees and board members could make it difficult for them to fully understand the requirements of ethics policies and statute.

ERS's policy requires six hours of training annually for all employees, but it does not specify how many hours must be related to ethics. Additionally, ERS does not track ethics training that its investment division conducts for its employees. In a sample of 22 ERS employees, 19 (86.4 percent) received ethics training in 2007; in a sample of 25 ERS employees, 23 (92.0 percent) received ethics training in 2008.<sup>13</sup> ERS has a goal of conducting (1) annual training for members of its board of trustees and investment advisory council

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<sup>12</sup> In the survey, 97.4 percent of ERS employees strongly agreed or agreed with that statement, 84.5 percent of TRS employees strongly agreed or agreed with that statement, and 100 percent of UTIMCO employees strongly agreed or agreed with that statement.

<sup>13</sup> The sample sizes were different for each year because some employees in the samples were hired after 2007 or left ERS before 2008.

and (2) biennial training for employees covered by its ethics policy. However, the ERS ethics policy does not require ethics training on a defined, recurring schedule. The policy specifies only that ethics training for members of the board of trustees should occur periodically.

UTIMCO requires all employees to receive ethics training when they are hired and to attend annual ethics training. Auditors tested a random sample of 30 employees from 2006 through 2008 and determined that 29 (96.7 percent) had received training as required.

#### Criminal Background Checks for Job Applicants and Existing Employees

UTIMCO does not conduct criminal background checks on its job applicants or existing employees. TRS conducts Department of Public Safety (DPS) criminal background checks for all job applicants, but it does not conduct recurring criminal background checks for existing employees.

ERS performs DPS criminal background checks for in-state job applicants, and it performs FBI criminal background checks for job applicants who have lived out of state for the past year. ERS also conducts a DPS criminal background check when an existing employee is promoted, and its policy authorizes criminal background checks on existing employees when there is reasonable cause, though it has not done so.

DPS criminal background checks identify offenses only in Texas, but FBI criminal background checks identify offenses nationwide. Conducting FBI background checks for job applicants and existing employees could help all three entities identify individuals with a history of unethical or criminal behavior.

#### Processes for Reporting Violations of Ethics Policies Anonymously

TRS does not have a process for employees to report violations of its ethics policy anonymously. In the State Auditor's Office survey, TRS had the lowest percentage of employees who strongly agreed or agreed with the statement "I can report ethical violations without fear of retaliation against me."<sup>14</sup> (See Appendix 3 for additional survey details.)

Although ERS and UTIMCO have processes for employees to report violations of ethics policies anonymously, respondents' comments on the State Auditor's Office survey suggest that ERS and UTIMCO should strengthen efforts to make employees aware of the existence of these processes. Auditors also noted that:

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<sup>14</sup> In the survey, 89.8 percent of ERS employees strongly agreed or agreed with that statement, 76.1 percent of TRS employees strongly agreed or agreed with that statement, and 98.2 percent of UTIMCO employees strongly agreed or agreed with that statement.

- UTIMCO has an anonymous hotline that employees can use to report ethics violations. When an employee files a report through the hotline, notification of the report is submitted to up to five individuals at UTIMCO and at the University of Texas System, depending on the issue. However, no ethics policy violations were reported through this hotline between fiscal year 2006 and the first quarter of fiscal year 2009.
- ERS's policy permits ERS employees to submit an anonymous e-mail to the ERS general counsel. Two reports were filed through this process between fiscal year 2006 and the first quarter of fiscal year 2009. However, neither report related to violations of the ERS ethics policy.

### Recommendations

ERS, TRS, and UTIMCO should consider (1) conducting FBI criminal background checks on all job applicants for positions covered by their ethics policies and (2) conducting recurring FBI criminal background checks on all existing employees covered by their investment ethics policies.

#### ERS should:

- Require all investment staff to take a specific minimum number of hours of ethics-related training at least every two years, and track all ethics training employees receive to ensure that all employees covered by its ethics policy receive training.
- Revise its ethics policy to require employees covered by its ethics policy, members of its board of trustees, and members of its investment advisory council to attend annual ethics training.

#### TRS should:

- Revise its ethics policy to require employees covered by its ethics policy and members of its board of trustees to attend annual ethics training.
- Establish and implement a process for employees to report violations of ethics policies anonymously.

# Appendices

Appendix 1

## **Objectives, Scope, and Methodology**

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### **Objectives**

The objectives of this audit were to:

- Determine whether the ethics policies for trustee investing practices of the Employees Retirement System (ERS), Teacher Retirement System (TRS), and The University of Texas Investment Management Company (UTIMCO) (investing entities) are consistent with applicable statutory requirements.
- Determine whether controls designed to help ensure compliance with ethics policies at the investing entities are working as intended.

### **Scope**

The scope of this audit covered ERS, TRS, and UTIMCO ethics policies and processes and controls related to ethics policies between September 1, 2005, and December 31, 2008.

### **Methodology**

The audit methodology included reviewing each entity's ethics policies and interviewing staff and board members. Auditors reviewed processes at ERS, TRS, and UTIMCO that are designed to ensure compliance with ethics policies. Auditors tested ethics compliance documentation to assess its effectiveness in detecting and preventing conflicts of interest.

Information collected and reviewed included the following:

- Investment ethics policies at ERS, TRS, and UTIMCO.
- Information on all conflicts of interest and ethics policy violations identified by ERS, TRS, and UTIMCO.
- Ethics compliance documents from ERS, TRS, and UTIMCO, including financial disclosure statements.
- Financial advisors' and service providers' conflict of interest disclosure statements.
- Outside employment disclosed by ERS, TRS, and UTIMCO employees and vendor-paid travel and gifts.

- Employees' personal security transactions disclosed to ERS, TRS, and UTIMCO, and security transactions made by ERS, TRS, and UTIMCO.
- Training records at ERS, TRS, and UTIMCO.
- Information from the Texas Ethics Commission.

Procedures and tests conducted included the following:

- Compared ERS, TRS, and UTIMCO ethics policies with applicable statutory requirements.
- Reviewed ERS, TRS, and UTIMCO processes for collecting various ethics documents to determine compliance with policy and statutory requirements.
- Analyzed disclosed conflicts of interest and ethics policy violations at ERS, TRS, and UTIMCO and determined whether they were resolved in accordance with policy and statutory requirements.
- Reviewed ERS, TRS, and UTIMCO processes for collecting conflict of interest statements from financial advisors and service providers, and determined whether those statements were filed in accordance with Texas Government Code, Chapter 2263.
- Reviewed ERS, TRS, and UTIMCO processes for reviewing and approving employees' outside employment and business activities.
- Reviewed ERS, TRS, and UTIMCO processes for reviewing and approving vendor-paid travel and gifts, and tested a judgmental sample for compliance with policies.
- Tested a random sample of ERS, TRS, and UTIMCO employees' personal securities transactions for compliance with policy and to ensure that ERS, TRS, and UTIMCO appropriately reviewed and approved employees' trades.
- Tested the controls in place at ERS, TRS, and UTIMCO to determine whether the entities adequately safeguarded confidential trade information.
- Reviewed the training requirements for ERS, TRS, and UTIMCO board members and employees and tested a sample of board members and employees to ensure they received ethics training in accordance with policies.
- Reviewed the hiring processes at ERS, TRS, and UTIMCO to determine whether the entities conducted sufficient criminal background checks on employees.

- Surveyed ERS, TRS, and UTIMCO investment staff to analyze their views of ethics policies at their entities.

Criteria used included the following:

- Texas Government Code, Chapter 815.
- Texas Government Code, Chapter 825.
- Texas Education Code, Chapter 66.08.
- Texas Government Code, Chapter 572.
- Texas Government Code, Chapter 2263.
- Investment ethics policies at ERS, TRS, and UTIMCO.
- Code of ethics of the Chartered Financial Analyst Institute.
- *State of Texas Contract Management Guide.*

### **Project Information**

Audit fieldwork was conducted from January 2009 through February 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The following members of the State Auditor's staff performed the audit:

- Scott Boston, MPAff (Project Manager)
- Lucien Hughes (Assistant Project Manager)
- Robert Burg, MPA
- Matt Byrnes
- Michael Clayton, CFE, CISA, CPA
- Jaime Navarro
- Amadou N'gaide, MBA, CFE
- Ken Wade

- Rachelle Wood, MBA, CISA (Information Systems Audit Team)
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Anita D’Souza, CFE (Audit Manager)

## ***Example of the Resolution of a Conflict of Interest Discussed at a Board Meeting***

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Below is an example of the resolution of a board member's conflict of interest at The University of Texas Investment Management Company (UTIMCO). This resolution was included in the minutes for the UTIMCO board meeting on July 23, 2008.

**RESOLUTION RELATED TO PROPOSED INVESTMENT IN  
RESERVOIR CAPITAL INVESTMENT PARTNERS (CAYMAN), L.P.**

WHEREAS, the Corporation's Private Investments staff has recommended an additional \$100 million commitment to Reservoir Capital Investment Partners (Cayman), L.P.; and

WHEREAS, such commitment exceeds the stated authority of the Corporation's staff in the Delegation of Authority Policy and requires the Corporation's Private Investments staff to provide Directors an option to review the proposed investment; and

WHEREAS, in lieu of providing Directors with an option to review the proposed investment, the Private Investments staff has presented the proposed investment to the Board at this meeting; and

WHEREAS, Director Ardon Moore has disclosed a conflict of interest in the proposed investment, which he acquired before the date he assumed his position on the Board and does not constitute a pecuniary interest as defined by Section 3.01(b) of the UTIMCO Code of Ethics (Code), and pursuant to Section 2.06(a) of the Code must absent himself from any deliberations related to the proposed investment and refrain from voting on the matter; and

WHEREAS, Section 3.03 of the Code provides that the Corporation may not invest in the private investments of a business entity if a director or director entity then owns a private investment in the same business entity unless: (a) the director or director entity acquired the private investment before the date on which the director assumed a position with UTIMCO; (b) the director's private investment does not constitute a pecuniary interest in a business entity as defined by Section 3.01(b) of the Code; and (c) the Board approves the investment by UTIMCO or the UTIMCO entity by a vote of two-thirds of the membership of the Board after a full disclosure in an open meeting of the relevant facts and a finding by the Board that the investment will not benefit the director or director entity financially; and

WHEREAS, Director Moore has disclosed his interest in Reservoir Capital Investment Partners (Cayman), L.P. and has absented himself from all deliberations related to the proposed investment as required by the Code.

NOW, THEREFORE, BE IT

RESOLVED, that the Board approves an additional \$100 million commitment to Reservoir Capital Investment Partners (Cayman), L.P. for the Permanent University Fund of the State of Texas and the Board of Regents of The University of Texas System General Endowment Fund (the "UT Funds") and directs staff to negotiate and enter into a contract with Reservoir Capital Investment Partners (Cayman), L.P. (the "Agreement"), conditioned on the receipt by the Chief Compliance Officer of UTIMCO of a certification of no pecuniary interest, as required by Section 4.04 of the UTIMCO Code of Ethics, from each director and key employee of UTIMCO.

RESOLVED FURTHER , that the Chief Executive Officer, the President and Deputy CIO, any Managing Director or Vice President, and the Secretary of this Corporation be, and each of them hereby is, authorized and empowered (any one of them acting alone) to do or cause to be done all such acts or things and to sign and deliver, or cause to be signed and delivered, all such documents, in the name and on behalf of the Corporation, in its capacity as the investment manager of the UT Funds or otherwise, as such officer of this Corporation may deem necessary, advisable or appropriate to effectuate or carry out the purposes and intent of the foregoing resolution and to perform the obligations of the UT Funds under the Agreement.

## Survey Results

In February 2009, the State Auditor's Office surveyed staff covered by the ethics policies at the Employees Retirement System (ERS), the Teacher Retirement System (TRS), and The University of Texas Investment Management Company (UTIMCO) to obtain their views on matters related to ethics policies. Table 2 summarizes the survey response rate, and Table 3 summarizes the survey results.

Table 2

Ethics Policy Survey Response Rate			
Entity	Number of Employees Surveyed	Number of Employees Who Responded to the Survey	Response Rate
ERS	56	39	69.6%
TRS	101	71	70.3%
UTIMCO	57	55	96.5%
Totals	214	165	77.1%

Table 3

Ethics Policy Survey Results <sup>a</sup>						
Entity	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Not Applicable
<b>1. I am confident that any ethics policy violations I report will be appropriately processed and resolved.</b>						
ERS	61.5%	33.3%	5.1%	-	-	-
TRS	62.0%	26.8%	7.0%	2.8%	-	1.4%
UTIMCO	83.6%	16.4%	-	-	-	-
<b>2. I understand what is required of me as an employee with regard to the ethics policy.</b>						
ERS	69.2%	30.8%	-	-	-	-
TRS	54.9%	43.7%	1.4%	-	-	-
UTIMCO	81.8%	16.4%	1.8%	-	-	-
<b>3. My manager/supervisor/ethics compliance officer/agency routinely communicates the importance of maintaining ethical standards.</b>						
ERS	59.0%	35.9%	2.6%	2.6%	-	-
TRS	60.6%	36.6%	1.4%	1.4%	-	-
UTIMCO	69.1%	30.9%	-	-	-	-
<b>4. I am comfortable seeking ethical guidance from within the agency (from a supervisor/manager/compliance officer).</b>						
ERS	64.1%	33.3%	2.6%	-	-	-
TRS	57.7%	35.2%	7.0%	-	-	-
UTIMCO	78.2%	20.0%	1.8%	-	-	-

Ethics Policy Survey Results <sup>a</sup>						
Entity	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Not Applicable
<b>5. I know who is authorized to obtain confidential investment information at my agency.</b>						
ERS	35.9%	41.0%	12.8%	7.7%	2.6%	-
TRS	43.7%	43.7%	7.0%	2.8%	1.4%	1.4%
UTIMCO	50.9%	25.5%	16.4%	1.8%	-	5.5%
<b>6. I know how to respond if an unauthorized person asks me to disclose confidential investment information.</b>						
ERS	51.3%	41.0%	2.6%	2.6%	2.6%	-
TRS	50.7%	42.3%	5.6%	1.4%	-	-
UTIMCO	65.5%	27.3%	7.3%	-	-	-
<b>7. I can report ethical violations without fear of retaliation against me.</b>						
ERS	51.3%	38.5%	10.3%	-	-	-
TRS	42.3%	33.8%	16.9%	5.6%	-	1.4%
UTIMCO	69.1%	29.1%	1.8%	-	-	-
<b>8. Ethics training within the agency is adequate and helps me understand what is expected of me as an employee.</b>						
ERS	64.1%	33.3%	2.7%	-	-	-
TRS	36.6%	47.9%	12.7%	2.8%	-	-
UTIMCO	72.7%	27.3%	-	-	-	-
<b>9. There is a way for me to anonymously report ethics violations.</b>						
ERS	38.5%	35.9%	25.6%	-	-	-
TRS	31.0%	31.0%	32.4%	4.2%	1.4%	-
UTIMCO	69.1%	20.0%	9.1%	-	-	1.8%
<sup>a</sup> The percentages in the rows of this table do not always sum precisely to 100 percent due to rounding.						

## Management's Responses

Management's responses from the Employees Retirement System are presented below.



**EMPLOYEES  
RETIREMENT  
SYSTEM OF TEXAS**

*Ann S. Fuelberg*  
Executive Director

*Yolanda Griego*  
Chair  
*I. Craig Hester*  
Vice Chair

*Board of Trustees*  
*Cydney C. Donnell*  
*Don Green*  
*Owen Whitworth*  
*Donald E. Wood*

Responses to An Audit Report on Ethics Policies for Trustee Investing Practices at the Employees Retirement System, the Teacher Retirement System, and The University of Texas Investment Management Company

**Chapter 2 – ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying Potential Conflicts of Interest, Monitoring Employees' Personal Securities Trades, and Safeguarding Confidential Investment Information**

**Chapter 2-A – ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Board Members' Potential Conflicts of Interest**

Members of the ERS Board of Trustees annually file a detailed Personal Financial Statement (Financial Disclosure) with the Texas Ethics Commission (TEC) as required by law. Chapter 572 of the Texas Government Code sets forth in detail the requirement to complete and timely file the Financial Disclosure with the TEC. The TEC is mandated by law with regard to the enforcement of these requirements, which includes civil penalties for violations of the law's provisions.

In addition to state law requirements to file the Financial Disclosure with the TEC, Board members are bound by their constitutional and common law fiduciary duty of loyalty to ERS and members of the trust fund for which they serve as trustee. Moreover, the Investment Policy requires all ERS trustees who become aware of a personal conflict of interest that affects their duty owed to ERS not only to disclose that conflict, but also to cure it. The Investment Policy also specifies that all members of the Board of Trustees are governed in their personal investment activities by the Standards of Professional Conduct established by the CFA Institute (CFAI), and each trustee signs a yearly affirmation of compliance with the Code of Ethics of the CFAI.

ERS believes that the possibility of being found in breach of their fiduciary duty, in addition to the protections afforded by the TEC review of annual Financial Disclosure filings, serve to ensure that Board members fully disclose any possible issues that might create a conflict of interest between the Board member and the retirement system. ERS will consider whether or not it should regularly review public information to independently verify the completeness of the financial disclosure statements that board members submit.

18th & Brazos Streets ★ P.O. Box 13207 ★ Austin, Texas 78711-3207 ★ (512) 867-7711 ★ (877) 275-4377 toll-free

ERS Board members do not have access to the ERS trading system and do not make decisions regarding the purchase and sale of individual securities. The TEC receives the Financial Disclosures annually and is mandated by law with enforcing the Government Code requirements related to the filing of and issues involving the Financial Disclosure. The Board is responsible for the enforcement of the Investment Policy with respect to violations by individual trustees through resolutions of reprimand, censure, or other appropriate parliamentary measures, including requests for resignation. In light of the foregoing and the fiduciary duty of loyalty that all Board members owe to the retirement system, ERS does not believe it is necessary for the Financial Disclosure statements to be filed with the system's ethics compliance officer.

**Chapter 2-B – ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Employees' Potential Conflicts of Interest**

ERS' Personnel Policy and Procedures Manual (Personnel Policy) requires that an employee may be terminated from ERS if he accepts outside non-state employment or becomes engaged in private business where the activity or work hours interfere with the efficiency of the employee's performance of, or are considered to be in conflict with, the employee's position at ERS. Moreover, the Investment Policy requires that employees who become aware of a personal conflict of interest that affects their duty owed to ERS have an obligation not only to disclose that conflict, but to cure it. The full range of disciplinary options under ERS' Personnel Policy may be used with respect to ERS employees who violate these requirements, up to and including termination. In addition, ERS agrees with the State Auditor's recommendations to require all employees to sign annual affirmations that employees have no conflicts of interest, that they have disclosed and received approval for any outside employment or business activities and that that they are in compliance with the ERS ethics policy. In light of the foregoing, ERS does not believe it is necessary at this time to consider whether or not to regularly review public information to independently verify the completeness of the information that employees disclose.

The ERS Executive Director annually files a detailed Personal Financial Statement (Financial Disclosure) with the Texas Ethics Commission (TEC) as required by law. Chapter 572 of the Texas Government Code sets forth in detail the requirement to complete and timely file the Financial Disclosure with the TEC. The TEC is mandated by law with regard to the enforcement of these requirements, which includes civil penalties for violations of the law's provisions.

In addition to state law requirements to file the Financial Disclosure with the TEC, the Executive Director is bound by her state and common law fiduciary duty of loyalty to ERS and members of the trust fund. Moreover, the Investment Policy also requires the Executive Director, if she becomes aware

of a personal conflict of interest that affects their duty owed to ERS, not only to disclose that conflict, but also to cure it. The Investment Policy also specifies that all ERS staff responsible for investment decisions or who are involved in the management of the system's assets are governed in their personal investment activities by the Standards of Professional Conduct established by the CFA Institute (CFAI), and each covered employee, including the Executive Director, signs a yearly affirmation of compliance with the Code of Ethics of the CFAI.

ERS believes that the possibility of being found in breach of her fiduciary duty, in addition to the protections afforded by the TEC review of annual Financial Disclosure filings, serve to ensure that the Executive Director fully discloses any possible issues that might create a conflict of interest between her and the retirement system. Furthermore, the Executive Director is required to obtain the written approval from the Director of Internal Auditing of any of her personal transactions prior to making personal trades in which ERS is invested. The Executive Director is also required to report to Internal Audit, on a quarterly basis, any personal investment activities, and all broker confirmations of trades are sent directly to the Internal Auditor from any applicable broker of the Executive Director. In light of the foregoing and the fiduciary duty of loyalty that the Executive Director owes to the retirement system, ERS does not believe it is necessary for the Financial Disclosure statements to be filed with the system's ethics compliance officer.

The ERS Investment Policy requires that all ERS investment staff as well as investment accounting staff, must obtain the written approval of the Deputy Executive Director of Investments prior to making personal trades in securities in which ERS is invested. Similarly, the Deputy Executive Director of Investments must obtain approval from the Chief Operating Officer, and the Chief Operating Officer must receive prior trade approval from the Executive Director. In addition, the Investment Policy requires that employees who become aware of a personal conflict of interest that affects their duty owed to ERS have an obligation not only to disclose that conflict, but also to cure it.

The ERS Investment Policy also specifies that all ERS staff responsible for investment decisions or who are involved in the management of the system's assets are governed in their personal investment activities by the Standards of Professional Conduct established by the CFAI, and each covered employee signs a yearly affirmation of compliance with the Code of Ethics of the CFAI. In addition, ERS agrees with the State Auditor's recommendations to require all employees to sign annual affirmations that employees have no conflicts of interest, that they have disclosed and received approval for any outside employment or business activities and that they are in compliance with the ERS ethics policy. In light of the foregoing, ERS does not believe it is necessary to require all employees who are involved in investment decisions to file financial disclosure statements internally.

Affirmations that covered employees have no conflicts of interest, that they have disclosed and received approval for any outside employment or business activities, and that they are in compliance with the ERS ethics policy will be added to the annual ERS Code of Ethics and Personal Investment Activities statement.

**Chapter 2-C – ERS, TRS and UTIMCO Should Strengthen Processes for Identifying and Resolving Contractors’ Potential Conflicts of Interest**

Effective April 15, 2009, the Executive office will maintain a spreadsheet to document the receipt and disposal of each gift received at ERS.

**Chapter 2-D – ERS, TRS, and UTIMCO Should Strengthen Processes for Monitoring Employees’ Personal Securities Trades and Safeguarding Confidential Investment Information**

Affirmations that covered employees do not have any undisclosed brokerage accounts and that they have not conducted any undisclosed personal securities trades will be added to the quarterly ERS Report of Personal Securities Transactions.

ERS consistently enforces and tracks violations of personal trading policies. The instance referenced in the SAO audit has been under investigation and appropriate action is being taken.

All personal trades for ERS covered staff are compared to the ERS trade history to analyze the timing of the personal trades. In addition, each personal trade is compared to the ERS holdings to determine whether appropriate pre-trade approval was obtained by staff. ERS will consider whether additional tracking of staff personal trades is necessary to facilitate further analysis.

Effective April 15, 2009, the ERS Investment Compliance Auditor will be required to comply with the ERS investment ethics policy. The Investment Compliance Auditor is part of the ERS Internal Audit staff which has always been required to follow auditor standards and the code of ethics established by the Institute of Internal Auditors and the Government Accountability Office.

**Chapter 3 – ERS, TRS, and UTIMCO Should Provide Regular Ethics Training, Strengthen Their Criminal Background Checks, and Implement or Strengthen Processes for Employees to Report Ethics Violations Anonymously**

ERS conducts criminal background checks on all individuals before they are hired. If a person has not lived in the state of Texas for the past two years, then an FBI criminal background check is conducted on that individual prior to

hire. Otherwise, ERS utilizes the criminal background check offered by the Texas Department of Public Safety for all persons before they are hired. ERS will consider whether or not it should conduct FBI criminal background checks on all persons, prior to being hired, for positions covered by the Investment ethics policy.

In accordance with ERS' Personnel Policy, current ERS employees are required to self-report to the employee's supervisor, Division Director, General Counsel, or Human Resources manager for: (a) felonies; or (b) any other crimes reflecting a lack of good moral character, lack of trustworthiness, or that the person may pose a continuing danger to others committed within the past ten years. Failure to report a conviction may result in corrective action up to and including termination of employment. ERS will consider whether or not it should conduct FBI criminal background checks on all existing employees covered by the Investment ethics policy.

ERS is in compliance with the recommendation for all staff to take a specific number of hours of ethics-related training. All ERS Investments staff are required to attend at least one ethics training class every two years. ERS employees' attendance is logged into an electronic system by Human Resources once attendance has been confirmed. All Board and Investment Advisory Committee members receive ethics training at the Board/IAC meeting held in either October or November of each year. In addition, ERS' Investment Policy is currently being reviewed by Ennis Knupp, the plan consultant hired by the Board of Trustees at its February 24, 2009 meeting. ERS has requested that Ennis Knupp provide it with best practices with respect to all aspects of its Investment Policy, including the Code of Ethics.

Thank you for the opportunity to respond to the SAO Ethics Policies audit report.

Sincerely,



Ann S. Fuelberg  
Executive Director

Management's responses from the Teacher Retirement System are presented below.

**Teacher Retirement System  
of Texas**



1000 Red River Street  
Austin, Texas 78701-2698

EXECUTIVE DIRECTOR  
Ronnie G. Jung

800-223-8778 (512) 542-6400 [www.trs.state.tx.us](http://www.trs.state.tx.us)

April 16, 2009

Mr. John Keel, CPA  
State Auditor  
P. O. Box 12067  
Austin, Texas 78701

Dear Mr. Keel:

Attached please find the TRS Management Responses Summary to the SAO Audit of Ethics Policies for Trustee Investing Practices.

Please let me know if you have any questions.

Sincerely,

A handwritten signature in blue ink that reads "Ronnie Jung".

Ronnie Jung

Tel. (512) 542-6401

Fax. (512) 542-6585

**SAO Audit of Ethics Policies for Trustee Investing Practices  
at ERS, TRS, and UTIMCO**

**TRS Management Responses Summary**

TRS Finding #	SAO Report Location	SAO Recommendation	TRS Division Responsible	TRS Management's Response
1	Chapter 2-A, pg. 6	Regularly review public information to independently verify the completeness of the financial disclosure statements that board members submit.	Legal Services	<p>Currently, as a result of the potential for a conflict of interest, as a matter of policy, in the absence of any expressed qualifications noted by the trustees, TRS trustees agree not to invest in TRS private equity vehicles. In the document entitled "Procedures and Representations of TRS Trustees and Certain Employees Regarding Private Equity Investments of TRS" (the "Representations Document"), attached hereto, if no qualifications are expressed by a given trustee, then the trustee represents that (i) neither he nor, to the best of his knowledge, any relative of his to the second degree, has acquired or has any current intention of acquiring a limited partnership interest or other ownership interest in a given partnership or fund and (ii) so long as he remains a TRS trustee, he will not acquire such an interest. Likewise, each trustee specifically represents that (i) neither he nor, to the best of his knowledge, any relative of his to the second degree, has an economic or beneficial interest in the general partner or investment manager of the subject partnership or fund and (ii) so long as he remains a trustee of TRS, he will not knowingly acquire such an interest.</p> <p>Similarly, through the use of standard language in side letters for private investment funds, the respective general partners of such funds represent, to the best of their knowledge, that no TRS trustee (i) has or will have any interest in the partnership, or (ii) has or will have any interest in TRS's investment in the partnership. Additionally, to the best of its knowledge, each respective general partner represents that none of the partnership, the manager, or any principal or employee having authority to act on behalf of the manager or its affiliates, has a personal or private relationship (including a commercial, investment, or business relationship) with (i) a TRS trustee, or with an employer of a TRS trustee (other than TRS) or (ii) an immediate family member of a TRS trustee (<i>i.e.</i>, a spouse, parent, child, sibling, niece, nephew, aunt, and/or uncle).</p> <p>Through the use of the Representations Document and the standard language in side letters for private investment funds, TRS seeks to prevent investments by a TRS trustee and by TRS itself in the same private investment opportunity.</p> <p>We note that SAO has acknowledged that there are few alternatives to the self-disclosure process. TRS has investigated using such public information sources as the</p>

**SAO Audit of Ethics Policies for Trustee Investing Practices  
at ERS, TRS, and UTIMCO**

**TRS Management Responses Summary**

TRS Finding #	SAO Report Location	SAO Recommendation	TRS Division Responsible	TRS Management's Response
				<p>Texas Secretary of State's SOSDirect and the U.S. Securities and Exchange Commission's EDGAR database. However, each of these sources has severe limitations as to what information is available.</p> <p>TRS will regularly review the public financial disclosure statements filed by trustees for potential conflicts of interest.</p> <p>Management estimates that TRS Legal Services will be able to implement this recommendation on or before July 15, 2009.</p>
2	Chapter 2-A, pg. 6	Regularly review board members' financial disclosure statements for potential conflicts of interest.	Legal Services	<p>TRS will regularly review the financial disclosure statements filed by trustees for potential conflicts of interest.</p> <p>Management estimates that TRS Legal Services will be able to implement this recommendation on or before July 15, 2009.</p>
3	Chapter 2-A, pg. 6	Require board members to simultaneously file copies of their financial disclosure statements with both the Texas Ethics Commission and with the agencies' ethics compliance officer.	Legal Services	<p>TRS is currently in the process of revising its ethics policies. Management will propose to the Board of Trustees that the Ethics Policy contain a provision requiring trustees to simultaneously file copies of their financial disclosure statements with both the Texas Ethics Commission and with TRS.</p> <p>Management estimates that the TRS Board will consider this recommendation on or before December 15, 2009.</p>
4	Chapter 2-B, pg. 8	Ethics compliance officers should regularly review public information to independently verify the completeness of the information that employees disclose.	Executive Director	<p>The Representations Document and the comments concerning the same that are found above also apply to TRS employees who actively participate in the decision-making process on behalf of TRS with regard to investments in private equity vehicles.</p> <p>As discussed above, public sources of financial information are limited. The TRS executive director will continue to review ethics financial statement disclosures annually.</p> <p>The Ethics Compliance Officer will also begin reviewing the financial statement disclosures</p> <p>Management estimates that TRS Legal Services will be able to implement this recommendation on or before July 15, 2009.</p>

**SAO Audit of Ethics Policies for Trustee Investing Practices  
at ERS, TRS, and UTIMCO**

**TRS Management Responses Summary**

TRS Finding #	SAO Report Location	SAO Recommendation	TRS Division Responsible	TRS Management's Response
5	Chapter 2-B, pg. 9	Require executive director to file financial disclosure statements with the agencies' ethics compliance officer at the same time that they submit these statements to the Texas Ethics Commission.	Executive Director	The TRS executive director currently provides a copy of his financial disclosure statements with the Chief Audit Executive. Copies will also be filed with the Ethics Compliance Officer. Implemented on April 16, 2009.
6	Chapter 2-B, pg. 9	Require all employees who are involved in investment decisions to file financial disclosure statements internally.	Legal Services	TRS already requires its "Key Employees" to annually file financial disclosure statements internally with the executive director, as required by statute. The executive director reviews these disclosure statements for potential conflicts of interest. Management believes this practice satisfies the intent of this recommendation and is fully implemented.
7	Chapter 2-C, pg. 12	Develop procedures to ensure that TRS notifies all financial advisors and service providers of the statutory requirement to file an annual conflict of interest disclosure statement. TRS should track submission of these statements to ensure that all financial advisors and service providers comply, and they should consider suspending business activities with service providers that do not submit disclosures by the filing due date.	Investments	The Investment Division presently handles the distribution and collection of ethics forms from brokers on the Approved Broker List; the Legal Services Division conducts these activities with regard to consultants, agents, and financial providers that are doing business with TRS. TRS has already developed practices to ensure that its financial advisors and service providers are informed of their statutory requirement to file an annual conflict of interest disclosure statement with both TRS and with the State Auditor's Office. Further, these practices track the submission of these statements to ensure that all financial advisors and service providers comply with the requirements of Chapter 2263, Texas Government Code. Management believes this practice satisfies the intent of this recommendation and is fully implemented.

**SAO Audit of Ethics Policies for Trustee Investing Practices  
at ERS, TRS, and UTIMCO**

**TRS Management Responses Summary**

TRS Finding #	SAO Report Location	SAO Recommendation	TRS Division Responsible	TRS Management's Response
8	Chapter 2-C, pg. 12	Ensure that all individuals working in the investment division are required to comply with the TRS investment ethics policy	Legal Services	Management is investigating available options to address the application of ethical standards, including those found in the Ethics Policy, to all individuals working in the Investment Division that are not employees of TRS, including revisions to its internal policies. Management will thereafter take action accordingly.  Management estimates that TRS Legal Services will be able to implement this recommendation on or before December 15, 2009.
9	Chapter 2-D, pg. 15	Require an annual statement from employees, as part of the ethics compliance statement, stating that the employees do not have any undisclosed brokerage accounts and that they have not conducted any undisclosed personal securities trades. The ethics policies should clearly state the penalties for conducting personal securities trades without prior disclosure.	Legal Services	The current Ethics Compliance Statement already includes a statement from each given employee that, to the best of his or her knowledge and belief, he or she has not violated the Ethics Policy or the Trading Policy. The employee is provided a blank in which to note any exceptions to this statement. Further, the Trading Policy itself requires each Tier 1 Employee <sup>1</sup> to annually, at a time determined by the Ethics Compliance Officer, submit to the Ethics Compliance Officer a certified listing of every Beneficial Ownership Account used by the Tier 1 Employee during the prior year, including broker name, address, account representative, account number, and the date opened and/or closed if the Beneficial Ownership Account was opened and/or closed during the reporting period. Therefore, management believes that the Ethics Compliance Statement already addresses the recommendation above concerning undisclosed brokerage accounts. Nonetheless, upon authority already granted by the Board of Trustees to the executive director, the executive director will add a statement to the Ethics Compliance Statement that specifically addresses undisclosed brokerage accounts, to be effective for all submissions due on or after May 1, 2009. Management will implement this recommendation on or before April 30, 2009.

<sup>1</sup> Tier 1 Employees are (a) Key Employees, (b) Investment Division employees, (c) Legal Services employees who work primarily on TRS investments, and (d) the spouses and minor children and other dependents of the above noted employees.

**SAO Audit of Ethics Policies for Trustee Investing Practices  
at ERS, TRS, and UTIMCO**

**TRS Management Responses Summary**

TRS Finding #	SAO Report Location	SAO Recommendation	TRS Division Responsible	TRS Management's Response
10	Chapter 2-D, pg. 15	Consistently enforce penalties for violations of personal trading policies and track verbal warnings given to employees regarding their personal trades.	Executive Director	Management will develop procedures for enforcing penalties for violations of the Trading Policy and for tracking verbal warnings given to employees regarding their personal trades. Management will implement this recommendation on or before August 30, 2009.
11	Chapter 2-D, pg. 15	Strengthen access controls by limiting the number of system administrator accounts for the Bloomberg System.	Senior Managing Director - Investments Administration Center	TRS agrees and has eliminated one administrator in February 2009, leaving four administrators to implement Bloomberg enhancements, correct Bloomberg related technical issues, set up and maintain Bloomberg accounts, grant access and permissions in the system and to have appropriate backups for each of these functions. We consider the current number of administrators as the minimum necessary to meet the business needs of TRS. Implemented on February 27, 2009.
12	Chapter 2-D, pg. 16	Ensure that only individuals who are required to comply with its investment ethics policy have access to confidential trade information.	Senior Managing Director - Investments Administration Center	TRS agrees with the recommendation and will determine whether or not any TRS staff meet these conditions, assess TRS's requirements, and make a determination to eliminate access based on the business needs of the Investment Division. Management will implement this recommendation on or before June 30, 2009.
13	Chapter 3, pg. 19	Consider (1) conducting FBI criminal background checks on all job applicants for positions covered by their ethics policies and (2) conducting recurring FBI criminal background checks on all existing employees covered by their investment ethics policies.	Director - Human Resources Legal Services	With regard to conducting initial FBI criminal background checks as well as conducting such checks on a recurring basis, management will explore (i) the appropriate employee population who will be subject to these checks and (ii) the limitations in state law on the conducting of these checks, if any. Management will also consider the use of a self-reporting mechanism in lieu of conducting recurring FBI criminal background checks.  Management estimates that Human Resources and Legal Services will be able to implement this recommendation on or before December 15, 2009.

**SAO Audit of Ethics Policies for Trustee Investing Practices  
at ERS, TRS, and UTIMCO**

**TRS Management Responses Summary**

TRS Finding #	SAO Report Location	SAO Recommendation	TRS Division Responsible	TRS Management's Response
14	Chapter 3, pg. 20	Revise its ethics policy to require employees covered by its ethics policy and members of its board of trustees to attend annual ethics training	Legal Services	As noted above, TRS is currently in the process of revising its ethics policies. Management will propose to the Board of Trustees that the revised policies contain provisions requiring trustees and employees to attend annual ethics training.  Management estimates that the Board will consider this recommendation on or before December 15, 2009.
15	Chapter 3, pg. 20	Establish and implement a process for employees to report violations of ethics policies anonymously	Executive Director / Deputy Director	Management will propose procedures for employees to anonymously report violations of the policy and will modify forms and reporting requirements, as applicable.  At the April 2009 Audit Committee meeting, Internal Audit recommended implementing a hot line for anonymous reporting by TRS employees. Management accepted the recommendation and has set a December 15, 2009 implementation date.

Management's responses from The University of Texas Investment Management Company are presented below.



Bruce Zimmerman  
CEO and Chief Investment Officer

April 15, 2009

Mr. John Keel, CPA  
State Auditor  
State Auditor's Office  
P.O. Box 12067  
Austin, Texas 78711-2067

**Subject: Management's Responses to Audit of Ethics Policies for Trustee Investing Practices at ERS, TRS, and UTIMCO**

Dear Mr. Keel:

Thank you for the opportunity to provide management's responses to the recommendations made by your office resulting from the audit of UTIMCO's Ethics Policies for Trustee Investing Practices. We appreciate the efforts of your staff to gain an understanding of UTIMCO practices with regards to its ethics policies and welcome their recommendations. The audit was conducted by your staff in an efficient and open manner.

The following UTIMCO Management's Responses track the outline of the draft copy of the Audit Report provided by your office to UTIMCO:

*Chapter 2*

***ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying Potential Conflicts of Interest, Monitoring Employees' Personal Securities Trades, and Safeguarding Confidential Investment Information***

**1. Chapter 2-A - ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Board Members' Potential Conflicts of Interest**

**Recommendations**

(a) ERS, TRS, and UTIMCO should consider regularly reviewing public information to independently verify the completeness of the financial disclosure statements that board members submit.

Tel 512-225-1600 • Fax 512-225-1660 • 401 Congress Avenue, Suite 2800 • Austin, TX 78701  
THE UNIVERSITY OF TEXAS INVESTMENT MANAGEMENT COMPANY

Mr. John Keel, CPA  
April 15, 2009  
Page 2

**Management's Response**

(a) Management agrees and, to the extent practicable, will begin regular review of SEC Edgar and Secretary of State databases to independently verify the completeness of the financial disclosure statements submitted by board members.

**2. Chapter 2-B - ERS, TRS, and UTIMCO Should Strengthen Processes for Identifying and Resolving Employees' Potential Conflicts of Interest**

**Recommendations**

(a) ERS, TRS, and UTIMCO ethics compliance officers should consider regularly reviewing public information to independently verify the completeness of the information that employees disclose.

(b) ERS and UTIMCO should require all employees covered by their investment ethics policies to sign annual statements affirming that they have disclosed and received approval for any outside employment or business activities.

**Management's Response**

(a) Management agrees and, to the extent practicable, will begin regular review of SEC Edgar and Secretary of State databases to independently verify the completeness of the financial disclosure statements submitted by employees.

(b) UTIMCO currently requires employees designated as "Key Employees" (as defined in the UTIMCO Code of Ethics) to obtain approval from the CEO before beginning any outside employment. Management has requested the disclosure of outside employment by all employees on the Financial Disclosure Statements due to Management by April 30, 2009, and will make this disclosure an annual requirement. Management will begin to require approval for outside employment of business activities for all employees. Management does not agree that annual re-approval for outside employment should be required.

**3. Chapter 2-C - ERS, TRS and UTIMCO Should Strengthen Processes for Identifying and Resolving Contractors' Potential Conflicts of Interest**

**Recommendations**

(a) TRS and UTIMCO should develop procedures to ensure that they notify all financial advisors and service providers of the statutory requirement to file an annual conflict of interest disclosure statement. The entities should track submission of these statements to ensure that all financial advisors and service providers comply, and they should consider suspending business activities with service providers that do not submit disclosures by the filing due date.

Mr. John Keel, CPA  
April 15, 2009  
Page 3

(b) ERS and UTIMCO should consider tracking the receipt and disposal of all prohibited gifts they receive.

(c) UTIMCO should:

- Ensure that it distributes its list of restricted securities to all external investment managers.
- Review and approve vendor-paid entertainment and establish a specific process for employees to request approval.
- Consider including on its travel approval form a list of all expenses, including entertainment expenses, that will be paid for by a third party.

**Management's Response**

(a) UTIMCO has continually maintained procedures to notify financial advisors and service providers of the Texas Government Code Chapter 2263 requirement to file an annual conflict of interest disclosure statement. Additionally, UTIMCO has maintained spreadsheets for each year to track notifications, reminders, and receipt of the annual conflict of interest disclosure statements. UTIMCO however, inadvertently failed to send statements to 9 financial advisors and service providers out of approximately 150 total financial advisors and service providers for the calendar year 2007. UTIMCO has since documented and enhanced its procedures for the 2008 calendar year to include reconciliation of front office and back office records to ensure that all financial advisors and service providers are notified.

(b) UTIMCO will consider tracking the receipt and disposal of all prohibited gifts received by UTIMCO employees.

(c) UTIMCO has sufficient processes in place to ensure that it distributes its list of restricted securities to all external investment managers. Nonetheless, on one occasion during its fourteen years of operation, UTIMCO failed to distribute its list of restricted securities to an external investment manager. The manager involved was not one with whom UTIMCO regularly does business; rather, the manager was engaged at the request of The University of Texas System Development Office to accommodate a special request of a donor to a University of Texas System institution. Upon discovery, UTIMCO promptly self-disclosed this single instance of notice failure.

The UTIMCO Code of Ethics requires employees to request CEO or Chief Compliance Officer approval to attend seminars, conferences, and other sponsored events that include entertainment or recreation. In almost every case, approval was properly requested and granted, but this has not been documented in a standard format. Management has revised its Travel Approval and Reconciliation Detail to include areas for disclosure and approval of vendor paid travel and entertainment to ensure consistent documentation.

Mr. John Keel, CPA  
April 15, 2009  
Page 4

Chapter 2-D

**ERS, TRS, and UTIMCO Should Strengthen Processes for Monitoring Employees' Personal Securities Trades and Safeguarding Confidential Investment Information**

**Recommendations**

(a) ERS, TRS, and UTIMCO should:

- Consider requiring an annual statement from employees, as part of the ethics compliance statement, stating that the employees do not have any undisclosed brokerage accounts and that they have not conducted any undisclosed personal securities trades. The ethics policies should clearly state the penalties for conducting personal securities trades without prior disclosure.
- Consistently enforce penalties for violations of personal trading policies and track verbal warnings given to employees regarding their personal trades.

(b) ERS and UTIMCO should consider tracking employee personal trade disclosure information to facilitate analysis of this information.

(c) TRS and UTIMCO should strengthen access controls by limiting the number of system administrator accounts for the Bloomberg System.

(d) UTIMCO should:

- Consider obtaining independent broker confirmations of employees' personal securities trades.
- Prohibit the use of shared accounts for the Bloomberg System.

**Management's Response**

(a) Because UTIMCO equity trading is less than one percent (1%) of UTIMCO total trading, the potential for conflicts of interest is minimal, and therefore, the risk to UTIMCO of prohibited trading is very low. Nonetheless, UTIMCO will modify its transactional disclosure form for documenting of personal securities transactions to require an employee to acknowledge that he/she does not have any undisclosed brokerage account and has not conducted any undisclosed personal securities trades. UTIMCO will not include specific penalties for conducting personal securities trades without prior disclosure in UTIMCO's Code of Ethics, but rather will evaluate instances of violations of employee personal securities trading provisions on a case-by-case basis. UTIMCO will maintain documentation of warnings given and penalties assessed for violation of employee personal securities trading provisions.

Mr. John Keel, CPA  
April 15, 2009  
Page 5

(b) UTIMCO equity trading is less than one percent (1%) of UTIMCO total trading so the potential for conflicts of interest is minimal. There have been no instances of conflicts of interest as a result of employee personal securities trading. Failures to comply with the UTIMCO Code of Ethics are limited to failure to request preclearance and failure to file the transactional disclosure form within ten (10) calendar days. The preclearance process was changed effective August 14, 2008, thereby streamlining the preclearance process. Employee personal trade disclosure information is reviewed upon receipt by assigned staff and the UTIMCO Chief Compliance Officer regularly reviews compliance with employee personal securities transaction processes. Management will consider obtaining personal trade disclosure information from employees electronically so that it can be easily accumulated to facilitate analysis of the information obtained.

(c) UTIMCO is currently working with Bloomberg to create separate administrator accounts in the Bloomberg System so that UTIMCO employees will not be sharing accounts.

(d) Because UTIMCO equity trading is less than one percent (1%) of UTIMCO total trading, the potential for conflicts of interest is minimal, and therefore, the risk to UTIMCO of prohibited trading is very low. Nonetheless, UTIMCO will consider obtaining independent broker confirmation of employees' personal securities trades.

UTIMCO is currently working with Bloomberg to create separate administrator accounts in the Bloomberg System so that UTIMCO employees will not be sharing accounts.

*Chapter 3*

***ERS, TRS, and UTIMCO Should Provide Regular Ethics Training, Strengthen Their Criminal Background Checks, and Implement or Strengthen Processes for Employees to Report Ethics Violations Anonymously***

**Criminal Background Checks for Job Applicants and Existing Employees**

**Recommendations**

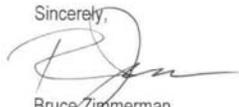
ERS, TRS, and UTIMCO should consider (1) conducting FBI criminal background checks on all job applicants for positions covered by their ethics policies and (2) conducting recurring FBI criminal background checks on all existing employees covered by their investment ethics policies.

Mr. John Keel, CPA  
April 15, 2009  
Page 6

**Management's Response**

- (a) Management agrees. Prior to the issuance of this recommendation, Management had created a committee composed of UTIMCO employees to explore and develop a policy regarding background checks on all UTIMCO employees. The committee has developed a draft policy and is currently interviewing third party providers for assistance with performing the background checks.

Sincerely,



Bruce Zimmerman  
CEO and Chief Investment Officer

cc: Charlie Chaffin, UT System Audit Office  
Jerry Turner, Andrews Kurth LLP  
Cecilia Gonzalez

## Recent State Auditor's Office Reports

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Recent SAO Work		
Number	Product Name	Release Date
09-017	A Report on the Audit of the Employees Retirement System's Fiscal Year 2008 Financial Statements	January 2009
09-015	A Report on the Audit of the Teacher Retirement System's Fiscal Year 2008 Financial Statements	December 2008

Copies of this report have been distributed to the following:

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The Honorable Rene Oliveira, House Ways and Means Committee

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