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State Auditor

An Audit Report on

**Incentive Compensation at the
Teacher Retirement System, the
Permanent School Fund, the
General Land Office, and the
Employees Retirement System**

May 2014

Report No. 14-033



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Overall Conclusion

Through their incentive compensation plans for plan year 2013, the Teacher Retirement System (TRS), the Permanent School Fund (PSF) of the Texas Education Agency, and the General Land Office made incentive compensation awards to employees in accordance with their policies and procedures. The Employees Retirement System (ERS) did not always award incentive compensation appropriately because it did not always award incentive compensation in accordance with its policies and procedures.

Incentive Compensation for Plan Year 2013

TRS, the PSF, ERS, and GLO awarded a total of \$9,665,385 in incentive compensation to 210 employees through their incentive compensation plans for plan year 2013. Specifically:

- TRS awarded \$5,489,499 to 111 employees.
- The PSF awarded \$838,838 to 35 employees.
- GLO awarded \$259,747 to 3 employees.
- ERS awarded \$3,077,301 to 61 employees.

In addition, the PSF, GLO, and ERS should strengthen their incentive compensation plans by formally approving those plans prior to the start of the plan performance period. The commissioner of education approved the PSF incentive compensation plan after the performance period had begun, and the ERS board of trustees did not formally approve the ERS incentive compensation plan prior to the beginning of the plan year. GLO did not provide evidence of the formal approval of its incentive compensation plan during this audit.

Auditors communicated other, less significant issues separately to TRS, the PSF, ERS, and GLO management in writing.

Summary of Management's Response

Management of the PSF, ERS, and GLO agreed with the recommendations in this report. However, auditors have included a follow-up comment to address some of the information in the management response from ERS (see Chapter 4). This report did not address any recommendations to TRS.

Summary of Information Technology Review

Auditors tested access controls over spreadsheets containing incentive compensation calculations at TRS, the PSF, GLO, and ERS and concluded that access controls at all four entities were adequate.

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

For more information regarding this report, please contact Angelica Ramirez, Audit Manager, or John Keel, State Auditor, at (512) 936-9500.

Summary of Objective, Scope, and Methodology

The objective of this audit was to determine whether incentive compensation at TRS, the PSF, GLO, and ERS was calculated and paid in accordance with their policies and procedures.

The scope of this audit covered incentive compensation plan years ending September 30, 2013, at TRS; July 31, 2013, at the PSF; June 30, 2013, at GLO; and August 31, 2013, at ERS.

The audit methodology included collecting information and documentation from the audited entities; reviewing incentive compensation plans, policies, and procedures, and other guidance related to incentive compensation; and analyzing and evaluating data and the results of tests. Using professional judgment, auditors selected a sample of incentive compensation payments at TRS, ERS, and the PSF. Auditors tested the entire population of incentive compensation payments at GLO. Auditors verified that recipients tested were eligible to receive incentive compensation payments, that data inputs used in calculations were correct, and that payment amounts were calculated correctly based on the terms of the incentive compensation plans. As noted above, auditors also tested access controls at the audited entities.

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Detailed Results

Chapter 1

TRS Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The TRS Incentive Compensation Plan

TRS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis.

Source: *Pure View Report*, State Street Global Services.

The qualitative (discretionary, non-performance-based) portion of the TRS incentive compensation payment calculation represents 20 percent of the incentive compensation payment for each eligible employee.

The Teacher Retirement System (TRS) awarded incentive compensation for its plan year ended September 30, 2013, in accordance with its policies and procedures.

TRS awarded a total of \$5,489,499 in incentive compensation to 111 employees.¹ TRS awarded the most incentive compensation to its chief investment officer, who received \$264,240 payable over a two-year period. That \$264,240 represented 5 percent of the \$5,489,499 in total incentive compensation that TRS awarded.

The TRS incentive compensation plan is based on a combination of investment performance and qualitative performance. The investment performance component compares investment performance with benchmarks and the performance of other large public funds. The qualitative performance component assesses performance in a variety of areas such as ethics, decision making and judgment, and analytical skills.

The TRS incentive compensation plan measures investment performance on both a one-year basis and a three-year basis. For the year ended September 30, 2013, TRS investments generated a positive return of 0.25 percent (25 basis points) over the preceding three-year period and a positive return of 0.94 percent (94 basis points) over the preceding one-year period. TRS's incentive compensation plan weights the three-year return twice as much as the one-year return. TRS met its goals for both the one-year and three-year periods; therefore, this triggered the awarding of incentive compensation.

¹ As of January 31, 2014, TRS had paid employees \$2,744,749 of the \$5,489,499 it awarded; \$2,744,750 was due to be paid in 2015.

Table 1 shows the positions eligible to earn incentive compensation in the TRS plan and the incentive compensation award range for each position for the 2013 plan year.

Table 1

TRS Incentive Compensation Awards for Plan Year 2013	
Eligible Position	Incentive Compensation Award Range (rounded to the nearest dollar) ^a
Chief Investment Officer	\$264,240
Deputy Director Investment Officer	\$161,847
Investment Fund Director	\$188,620
Portfolio Manager V	\$31,819 to \$165,682
Chief Trader II	No employee in this position was eligible for incentive compensation in plan year 2013
Portfolio Manager IV - Director	\$20,698 to \$116,489
Chief Trader I	\$88,290
Director V	\$99,625
Portfolio Manager IV - Manager	\$96,923
Portfolio Manager III	\$12,474 to \$91,994
Trader II	\$36,790 to \$46,484
Portfolio Manager II	\$44,960 to \$53,170
Portfolio Manager I	\$52,627 to \$66,476
Trader I (more than 4 years of experience)	\$26,439 to \$29,089
Investment Analyst IV	\$21,521 to \$57,379
Investment Analyst III	\$16,880 to \$36,444
Financial Analyst IV (Team Leader)	\$26,588 to \$34,993
Trader I (1-3 years of experience)	No employee in this position was eligible for incentive compensation in plan year 2013
Director IV	\$41,437
Director III	\$38,444
Director II	\$32,280
Director I	No employee in this position was eligible for incentive compensation in plan year 2013
Investment Analyst II	\$3,158 to \$21,527
Accountant VII	\$16,004 to \$21,213
Systems Analyst VI	\$19,301 to \$27,522
Program Specialist VII	No employee in this position was eligible for incentive compensation in plan year 2013
Accountant VI	\$12,229
Investment Analyst I (more than 4 years of experience)	\$7,630 to \$9,091
Financial Analyst III	\$8,610

TRS Incentive Compensation Awards for Plan Year 2013	
Eligible Position	Incentive Compensation Award Range (rounded to the nearest dollar) ^a
Program Specialist VI	\$12,244 to \$14,241
Systems Analyst V	No employee in this position was eligible for incentive compensation in plan year 2013
Investment Analyst I (1-3 years of experience)	\$6,909
Accountant V	No employee in this position was eligible for incentive compensation in plan year 2013
Accountant IV	No employee in this position was eligible for incentive compensation in plan year 2013
Accountant III	No employee in this position was eligible for incentive compensation in plan year 2013
Accountant II	No employee in this position was eligible for incentive compensation in plan year 2013
Executive Assistant III	No employee in this position was eligible for incentive compensation in plan year 2013
Financial Analyst II	\$3,800 to \$8,860
Financial Analyst I	No employee in this position was eligible for incentive compensation in plan year 2013
Training Specialist IV	\$5,890
Systems Analyst IV	No employee in this position was eligible for incentive compensation in plan year 2013
Systems Analyst III	No employee in this position was eligible for incentive compensation in plan year 2013
Program Specialist V	No employee in this position was eligible for incentive compensation in plan year 2013
Program Specialist IV	No employee in this position was eligible for incentive compensation in plan year 2013
Program Specialist III	\$6,078 to \$7,262
Admin Assistant V	\$1,083
Admin Assistant IV	\$1,103
Admin Assistant III	No employee in this position was eligible for incentive compensation in plan year 2013
Admin Assistant II	No employee in this position was eligible for incentive compensation in plan year 2013
Executive Assistant I	\$1,095 to \$1,379
Executive Assistant II	\$1,201 to \$1,249
Program Specialist II	No employee in this position was eligible for incentive compensation in plan year 2013
Program Specialist I	No employee in this position was eligible for incentive compensation in plan year 2013
^a A single amount is presented when only one individual was in the position for plan year 2013; a range of amounts is presented when multiple individuals were in the position for plan year 2013.	

Source: TRS.

The PSF Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The PSF Incentive Compensation Plan

The PSF calculates investment returns for its incentive compensation plan on a gross-of-fees-paid-to-external-manager basis.

Source: Mellon Bank performance calculation worksheet.

The PSF's calculation of incentive compensation is based only on performance and does not include a qualitative (discretionary, non-performance-based) portion.

The Permanent School Fund (PSF) of the Texas Education Agency awarded incentive compensation for its plan year ended July 31, 2013, in accordance with its policies and procedures.

The PSF awarded a total of \$838,838 in incentive compensation to 35 employees.² The PSF awarded the most incentive compensation to its deputy chief investment officer, who received \$101,201 payable over a two-year period. That \$101,201 represented 12 percent of the \$838,838 in total incentive compensation that the PSF awarded.

The PSF incentive compensation plan compares investment performance with a target benchmark on a three-year rolling basis. The PSF calculates incentive compensation based on an employee's achievement of goals in fund performance and asset class performance. Because the three-year investment performance exceeded the benchmark, this triggered the awarding of incentive compensation. Specifically, the total fund investment performance:

- Exceeded the target benchmark by 0.26 percent (26 basis points) for the three-year period from August 1, 2010, to July 31, 2013.
- Missed the target benchmark by 0.29 percent (29 basis points) for the one-year period from August 1, 2012, to July 31, 2013.

The PSF incentive compensation plan requires the commissioner of education to approve the list of participants who are eligible for the incentive compensation plan within 60 days of the plan's start date, or as soon as feasible. However, the PSF did not obtain that approval until August 7, 2013, which was after the end of the 2013 plan performance period.

Additionally, the commissioner of education did not formally approve the PSF incentive compensation plan until December of 2012, which was after the beginning of the 2013 plan performance start date. Obtaining formal approval of the incentive compensation plan prior to the beginning of the performance period could help to ensure that the plan aligns with the intent of the commissioner of education. It also could help to ensure compliance with Rider 22, page III-11, General Appropriations Act (82nd Legislature), which specified that payments from the incentive compensation plan "...must be based on investment performance standards set prior to the beginning of the period for which any additional compensation is paid." The commissioner of

² As of January 31, 2014, the PSF had paid employees \$419,419 of the \$838,838 it awarded; \$209,710 was due to be paid in late 2014 and \$209,709 was due to be paid in late 2015.

education approved the 2014 PSF incentive compensation plan prior to the start of that plan performance period.

Table 2 shows the positions eligible to earn incentive compensation in the PSF plan and the incentive compensation award range for each position for the 2013 plan year.

Table 2

The PSF Incentive Compensation Awards for Plan Year 2013	
Eligible Position	Incentive Compensation Award Range (rounded to the nearest dollar and paid over three years) ^a
Chief Investment Officer	\$79,070
Deputy Chief Investment Officer	\$101,201
Director of Fixed Income	No employee in this position was eligible for incentive compensation in plan year 2013
Director of Public Market Alternatives	\$79,505
Director of Equities	\$67,986
Director of Private Markets	\$50,578
Risk Manager	\$34,800
Portfolio Manager III	\$0 to \$64,409
Portfolio Manager II	\$0 to \$21,547
Deputy Executive Administrator	\$39,115
Investment Analyst IV	\$9,024 to \$26,428
Investment Analyst II	\$0 to \$14,550
Investment Analyst I	\$0 to \$8,442
Director of Investment Operations	\$25,293
Director of Finance Team Lead	\$9,316
Director of Alternative Assets	No employee in this position was eligible for incentive compensation in plan year 2013
Due Diligence and Trade Support Team Lead	No employee in this position was eligible for incentive compensation in plan year 2013
Director of Investment Technology	\$11,536
Financial Analyst IV	No employee in this position was eligible for incentive compensation in plan year 2013
Financial Analyst III	No employee in this position was eligible for incentive compensation in plan year 2013
Financial Analyst II	\$0 to \$7,053
Financial Analyst I	\$0 ^b
Accountant VI	No employee in this position was eligible for incentive compensation in plan year 2013
Attorney VII	\$0 ^b
Manager III	No employee in this position was eligible for incentive compensation in plan year 2013

The PSF Incentive Compensation Awards for Plan Year 2013	
Eligible Position	Incentive Compensation Award Range (rounded to the nearest dollar and paid over three years) ^a
Systems Analyst VI	\$0 to \$4,201
Systems Analyst IV	\$2,479
Program Specialist VII	\$0 ^b
Program Specialist V	No employee in this position was eligible for incentive compensation in plan year 2013
Staff Services Officer IV	No employee in this position was eligible for incentive compensation in plan year 2013
Staff Services Officer II	\$1,009
Executive Assistant	\$1,146
^a A single amount is presented when only one individual was in the position for plan year 2013; a range of amounts is presented when multiple individuals were in the position for plan year 2013. ^b During plan year 2013, the Permanent School Fund's total fund return did not meet its benchmark. As a result, individuals employed fewer than three years and whose incentive compensation payments were based on the total fund return did not receive an incentive compensation payment.	

Source: The PSF.

Recommendations

The PSF should:

- Ensure that the commissioner of education approves the list of participants eligible for the incentive compensation plan within 60 days of the plan start date.
- Ensure that the commissioner of education formally approves the incentive compensation plan prior to the beginning of the plan year.

Management's Response from the Texas Education Agency

- *PSF should ensure that the commissioner of education approves the list of participants eligible for the incentive compensation plan within 60 days of the plan start date.*

For future plan measurement periods, the plan provides for pro-rated participation by new PSF employees. As such, TEA will establish procedures to ensure that the Commissioner approves the list of eligible participants within 60 days of the start of the plan year for those employees on the payroll on the start date of the plan year. The list of eligible plan participants will need to be approved again at the end of the

plan year so that all eligible participants, including new employees, are captured and approved for participation.

- *PSF should ensure that the commissioner of education formally approves the incentive compensation plan prior to the beginning of the plan year.*

For future plan measurement periods, TEA management has ensured and will continue to ensure that the effective incentive compensation plan is formally approved by the commissioner of education prior to the beginning of any plan year.

GLO Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The GLO Incentive Compensation Plan

GLO calculates investment returns for its incentive compensation plan on a gross-of-fees-paid-to-external-manager basis.

Source: State Street Bank performance calculation worksheet.

The qualitative (discretionary, non-performance-based) portion of the GLO incentive compensation payment calculation represents 40 percent of the incentive compensation payment for each eligible employee.

The General Land Office (GLO) awarded incentive compensation for its plan year ended June 30, 2013, in accordance with its policies and procedures. However, during this audit GLO did not provide evidence that the land commissioner or the school land board formally approved the incentive compensation plan. Additionally, GLO did not maintain documentation to support the qualitative portion of its incentive compensation payment calculations.

GLO awarded a total of \$259,747 in incentive compensation to 3 employees.³ The GLO awarded the most incentive compensation to its deputy commissioner of funds management, who received \$200,186 payable over a two-year period. That \$200,186 represented 77 percent of the \$259,747 in total incentive compensation that the GLO awarded.

The GLO incentive compensation plan compares investment performance with a target benchmark on a five-year rolling basis. The GLO calculates incentive compensation based on an employee's achievement of goals in fund performance (60 percent) and a qualitative component (40 percent) that is tied to employee job performance for the period. Because investment performance exceeded the benchmark, this triggered the awarding of incentive compensation. Specifically, the total fund investment performance:

- Exceeded the target benchmark by 1.92 percent (192 basis points) for the five-year period from July 1, 2008, to June 30, 2013.
- Exceeded the target benchmark by 6.70 percent (670 basis points) for the three-year period from July 1, 2010, to June 30, 2013.
- Exceeded the target benchmark by 4 percent (400 basis points) for the one-year period from July 1, 2012, to June 30, 2013.

³ As of January 31, 2014, the GLO had paid employees \$129,874 of the \$259,747 it awarded; \$129,873 was due to be paid late in 2014.

Table 3 shows the positions eligible to earn incentive compensation in the GLO plan and the incentive compensation awarded for each position for the 2013 plan year.

Table 3

GLO Incentive Compensation Awards for Plan Year 2013	
Eligible Position	Incentive Compensation Award (rounded to the nearest dollar)
Deputy Commissioner of Funds Management	\$200,186
Real Assets Portfolio Manager	\$49,517
Senior Financial Analyst	No employee in this position was eligible for incentive compensation in plan year 2013
Program Specialist	\$10,044

Source: GLO.

Recommendations

GLO should:

- Ensure that the school land board or the land commissioner formally approves the incentive compensation plan prior to the beginning of the plan year.
- Retain documentation related to the qualitative portion of its incentive compensation plan calculations.

Management's Response

The GLO agrees with State Auditor's Office assessment and recommendations. The GLO will have the Chief Clerk or the Commissioner formally approve the incentive pay plan before the beginning of each plan year, since the School Land Board does not set or determine compensation for GLO employees.

The GLO will retain written documentation for the qualitative portion of the incentive compensation plan as it does for standard employee evaluations.

ERS Did Not Always Award Incentive Compensation in Accordance With Its Policies and Procedures

The ERS Incentive Compensation Plan

ERS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis.

Source: ERS incentive compensation plan.

The qualitative (discretionary, non-performance-based) portion of the ERS incentive compensation payment ranges from 0 percent to 90 percent of the incentive compensation payment for each eligible employee.

ERS did not always award incentive compensation for its plan year ended August 31, 2013, in accordance with its policies and procedures. Specifically, ERS did not always pay amounts that aligned with its incentive compensation plan, and it did not always maintain documentation to support the calculation of incentive compensation for some personnel.

ERS awarded a total of \$3,077,301 in incentive compensation to 61 employees.⁴ ERS awarded the most incentive compensation to its chief investment officer, who received \$157,953 payable over a three-year period. That \$157,953 represented 5 percent of the \$3,077,301 in total incentive compensation that ERS awarded.

The ERS incentive compensation plan is based on a combination of investment performance and qualitative performance. The investment performance component compares investment performance to a benchmark. The qualitative performance component assesses items such as an employee's development of hedge fund strategies and implementation of an emerging manager program. Because investment performance exceeded the benchmark, this triggered the awarding of incentive compensation. Specifically, the total fund investment performance:

- Exceeded the target benchmark by 0.25 percent (25 basis points) for the five-year period from September 1, 2008, to August 31, 2013.
- Exceeded the target benchmark by 0.20 percent (20 basis points) for the three-year period from September 1, 2010, to August 31, 2013.
- Exceeded the target benchmark by 0.34 percent (34 basis points) for the one-year period from September 1, 2012, to August 31, 2013.

Auditors identified the following areas in which ERS should strengthen the administration of its incentive compensation plan:

- ERS should strengthen the review process for its incentive compensation plan payment calculations to help ensure that amounts are paid accurately. ERS made errors in the calculation of 10 (26 percent) of the 39 incentive compensation plan payments that auditors tested, which resulted in 10 employees receiving incorrect payments. The errors resulted in employees receiving a net total of \$22,563 more than they should have received based

⁴ As of January 31, 2014, ERS had paid employees \$1,535,745 of the \$3,077,301 it awarded; \$385,389 was due to be paid later in 2014, and \$385,389 was due to be paid in 2015.

on the incentive compensation plan calculation methodology. The calculation errors were caused by use of incorrect formulas, incorrect weighting of plan inputs for individuals whose positions changed during the plan year, use of incorrect value inputs, and incorrect salary calculations.

- ERS used accurate amounts for the quantitative metric portion of its incentive compensation calculations. However, ERS did not consistently maintain source documentation for the quantitative metric that it used. Specifically, ERS did not maintain that documentation for 23 (38 percent) of the 61 participants in its incentive compensation plan. The ERS records retention schedule did not require ERS to maintain that documentation.
- The ERS board of trustees did not formally approve the 2013 incentive compensation plan prior to the beginning of the plan year. That increases the risk that the incentive compensation may not align with the intent of the board of trustees. The ERS board of trustees approved the 2014 incentive compensation plan prior to the start of that plan performance period.

Additional Incentive Compensation Plan Information

The ERS incentive compensation plan allows the ERS executive director to exercise discretion in plan-related matters. The following is an excerpt of plan section 7.1. For additional applicable sections, see Appendix 2.

7.1 The Plan shall be administered by the Board, as it relates to participation of the Executive Director, and by the Executive Director, as it relates to participation of other ERS employees, in accordance with the terms hereof, as amended from time to time. In administering the Plan, the Board or Executive Director, with input from ERS senior management, shall have discretionary authority to interpret the Plan document and to administer the Plan in accordance with its terms.

During the plan year, the ERS executive director used discretionary authority to expand the list of eligible incentive compensation plan participants to include legal staff and investment operations staff. The ERS board of trustees did not approve that change prior to the start of the plan year. See Appendix 3 for the details on the additional positions included in the incentive compensation plan.

Table 4 shows the positions eligible to earn incentive compensation under the ERS plan and the incentive compensation award range for each position for the 2013 plan year.

Table 4

ERS Incentive Compensation Awards for Plan Year 2013	
Eligible Position	Incentive Compensation Award Range (rounded to the nearest dollar) ^a
Executive Director	\$134,063
Chief Investment Officer	\$157,953
Asset Class Director	\$103,742 to \$139,597
Director of Strategic Research	\$103,362
General Counsel and Chief Compliance Officer	\$104,569
Investments and Securities, Attorney	\$5,935 to \$102,483
Portfolio Manager IV	\$56,643 to \$108,000
Portfolio Manager III	\$63,001 to \$76,869
Portfolio Manager II	\$22,196 to \$60,139
Portfolio Manager I	\$47,322 to \$54,964
Chief Trader	\$51,186 to \$71,160
Investment Analyst IV	\$24,389 to \$56,275
Investment Analyst III	\$6,000 to \$47,227
Investment Analyst II	No employee in this position was eligible for incentive compensation in plan year 2013
Investment Analyst I	No employee in this position was eligible for incentive compensation in plan year 2013
Trader II	No employee in this position was eligible for incentive compensation in plan year 2013
Trader I	\$14,718
Investments and Securities, Paralegal	\$14,768
Director of Investment Operations	\$46,251
Investment Operations Program Specialist IV	No employee in this position was eligible for incentive compensation in plan year 2013
Investment Operations Program Specialist III	No employee in this position was eligible for incentive compensation in plan year 2013
Investment Operations Program Specialist II	\$17,073
Investment Operations Program Specialist I	No employee in this position was eligible for incentive compensation in plan year 2013
Financial Analyst II	\$9,282 to \$15,965
Financial Analyst I	No employee in this position was eligible for incentive compensation in plan year 2013
Investments Administrative Support	\$146 to \$2,835

^a A single amount is presented when only one individual was in the position for plan year 2013; a range of amounts is presented when multiple individuals were in the position for plan year 2013.

Source: ERS.

Recommendations

ERS should:

- Strengthen its review process for plan payment calculations and related documents to help ensure that payments align with plan policies and procedures and that payments are supported.
- Update its records retention schedule to require ERS to retain source documentation for all quantitative metrics it uses to calculate incentive compensation payments. Because the ERS incentive compensation plan is based on performance periods of different lengths (currently, five years, three years, and one year), ERS should retain that documentation for a length of time that is equal to its most lengthy performance period.
- Ensure that the ERS board of trustees formally approves the incentive compensation plan prior to the beginning of a plan year.

Management's Response

The Employees Retirement System of Texas (ERS) agrees that it should strengthen its review process for plan payment calculations. ERS is currently evaluating factors that led to errors to ensure proper implementation of corrective action.

ERS also agrees that source documentation for quantitative metrics should be retained. As reported by the State Auditor's Office, accurate amounts were used for the quantitative metric portion of incentive compensation calculations. ERS will work with its Records Management Officer, who is also a Certified Records Manager (CRM), to ensure the records retention schedule is properly updated.

As reported the ERS Board of Trustees (Board) did approve the 2014 incentive compensation plan (ICP or plan) prior to the start of the plan performance year during the August 2013 Board meeting. However, the plan, as approved by the Board, specifies that it shall be administered by the executive director as it relates to participation of other ERS employees, in accordance with the terms of the plan. In Section 7.3, it is provided that the Board shall review the plan at least once every five years. Staff updates the Board at least annually regarding the ICP. ERS management will discuss with the Board its preference for future ICP approvals.

Sufficient information has not been provided to ERS related to the Additional Incentive Compensation Plan Information section and associated 20 pages of individual personnel action forms included in appendices, to address any potential concerns and possible corrective action. No instance of non-compliance with the stated audit scope objective or any recommendations to

improve operations related to this section were reported. ERS' Audit Committee Chair, through ERS' Internal Audit Division, has extended an invitation to the State Auditor's Office to present this report at the August 19, 2014 Audit Committee meeting to ensure any concerns are appropriately addressed by the ERS Audit Committee and Board of Trustees.

Auditor Follow-up Comment

The documents referred to as "personnel action forms" by ERS in its response are interoffice memos that explain the addition of certain ERS employees to the incentive compensation plan in 2013. The State Auditor's Office included this information to identify the process ERS followed to expand its incentive compensation plan.

Section 7.3 notwithstanding, the State Auditor's Office recommends that the ERS board of trustees approve the incentive compensation plan prior to the beginning of each plan year.

Appendices

Appendix 1

Objective, Scope, and Methodology

Objective

The objective of this audit was to determine whether incentive compensation at the Teacher Retirement System (TRS), the Permanent School Fund (PSF) of the Texas Education Agency, the General Land Office (GLO), and the Employees Retirement System (ERS) was calculated and paid in accordance with their policies and procedures.

Scope

The scope of this audit covered incentive compensation plan years ending September 30, 2013, at TRS; July 31, 2013, at the PSF; June 30, 2013, at GLO; and August 31, 2013, at ERS.

Methodology

The audit methodology included collecting information and documentation from the audited entities; reviewing incentive compensation plans, policies and procedures, and other guidance related to incentive compensation; and analyzing and evaluating data and the results of tests.

Using professional judgment, auditors selected a sample of incentive compensation payments at TRS, ERS, and the PSF. Auditors tested the entire population of incentive compensation payments at GLO. Auditors verified that recipients tested were eligible to receive incentive compensation payments, that data inputs used in calculations were correct, and that payment amounts were calculated correctly based on the terms of the incentive compensation plans. Auditors also tested access controls at the audited entities.

Auditors reviewed calculations, personnel files, payroll data, and externally reported fund performance results to determine whether the audited entities calculated and paid incentive compensation in accordance with policies and procedures. Auditors also tested access controls over the spreadsheets the entities used in calculating incentive compensation for authorized personnel.

Auditors did not conduct data reliability assessments. Those assessments were not necessary for the purposes of this audit because data was used only as support for testing information available at the audited entities.

Information collected and reviewed included the following:

- Incentive compensation plans at TRS, the PSF, GLO, and ERS.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending September 30, 2013, at TRS; July 31, 2013, at the PSF; June 30, 2013, at GLO; and August 31, 2013, at ERS.
- Incentive compensation recipients' personnel files.
- Payroll data related to incentive compensation recipients.
- Investment performance reports from custodian banks.

Procedures and tests conducted included the following:

- Interviewed management and key personnel at TRS, the PSF, GLO, and ERS.
- Analyzed and recalculated incentive compensation payments for incentive compensation plans years ending September 30, 2013, at TRS; July 31, 2013, at the PSF; June 30, 2013, at GLO; and August 31, 2013, at ERS.
- Reviewed and tested compliance with the audited entities' policies and procedures.

Criteria used included the following:

- *Teacher Retirement System of Texas Performance Incentive Pay Plan.*
- *Texas Permanent School Fund Performance Incentive Pay Plan.*
- *Texas General Land Office Performance Incentive Pay Plan.*
- *Employees Retirement System of Texas Incentive Compensation Plan.*
- ERS board of trustees meeting minutes.
- Section 44, Article III, Texas Constitution and related statutes.
- Rider 14, pages III-32 through III-33, and Rider 22, page III-11, General Appropriations Act (82nd Legislature).
- Rider 13, page III-32, and Rider 22, page III-11, General Appropriations Act (83rd Legislature).
- Texas attorney general opinions related to incentive compensation.

Project Information

Audit fieldwork was conducted from February 2014 through April 2014. 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:

- Michael O. Clayton, CPA, CISA, CIDA, CFE (Project Manager)
- Ashlee C. Jones, MAcy, CFE, CGAP (Assistant Project Manager)
- Michelle Lea DeFrance, CPA
- Michelle Ann Duncan Feller, CPA, CIA (Quality Control Reviewer)
- Angelica M. Ramirez, CPA (Audit Manager)

ERS Incentive Compensation Plan Excerpts Regarding Executive Director Discretion

Below are excerpts from the Employees Retirement System's incentive compensation plan.

- 7.2 All decisions of the Board or Executive Director, as applicable, shall be binding and conclusive on the Participants and ERS. Subject to the provisions of the Plan, the Board or Executive Director, as applicable, shall have the discretionary authority to:
- (a) approve Participants of the Plan, including determining eligibility for Plan Participants;
 - (b) approve Plan Year Participant Goals, and all aspects of the calculations for computing Incentive Compensation Awards;
 - (c) evaluate the performance of the employees and recommend Incentive Compensation Awards;
 - (d) exercise discretion in payment of Incentive Compensation Awards as discussed in Sections 6;
 - (e) establish policies and procedures for the administration of the Plan;
 - (f) interpret the Plan and make all decisions necessary to administer the Plan; and
 - (g) delegate the authority to administer all or any part of the Plan to ERS employees that are not Participants in the Plan during the respective Plan Year.

ERS Memos Regarding Inclusion of Legal and Investment Operations Staff in Its Incentive Compensation Plan

This appendix presents Employees Retirement System memos regarding the inclusion of certain employees in that agency's incentive compensation plan. The State Auditor's Office redacted the names of the employees discussed in these memos.

ERS

EMPLOYEES RETIREMENT SYSTEM
OF THE STATE OF TEXAS

2001, 15TH STREET, AUSTIN, TEXAS 78701-1130, BOX 1300, AUSTIN, TEXAS 78713-3001, (512) 867-7711, (877) 275-4377 TOLL FREE, WWW.ERS.STATE.TX.US

INTEROFFICE MEMORANDUM

DATE: July 31, 2012

TO: Ann S. Bishop, Executive Director
Larry Zeplin, Chief Operating Officer

THROUGH: Jacqueline Johnson, Deputy Executive Director of Investments 

FROM: Betty Martin, Director of Investment Operations 

SUBJECT: **ELIGIBILITY FOR INVESTMENT OPERATION'S STAFF IN THE ERS INCENTIVE COMPENSATION PLAN FOR KEY INVESTMENT PROFESSIONALS AND LEADERSHIP EMPLOYEES ("ICP")**

The purpose of this memo is to outline the contribution Investment Operations professionals provide to the success of the investment making process in the Investment Division and justify their inclusion in the ICP.

Recommendation

Subject to the discretion of the Executive Director and Chief Operating Officer and meeting other eligibility requirements of the ICP, each member of the Investment Operations team be considered eligible for the ICP and their respective positions added to Appendix A of the plan document because they meet the definition of "Investment Professional." We respectfully request consideration under the Executive Director's discretion to consider the eligibility of the Investment Operations team beginning September 1, 2012 with these additional recommendations:

1. Maximum Incentive Award Percentages for Operations staff (Program Specialist II-VI) ranging from 10-25%.
2. Performance Goals attributed to 20% Trust Fund Performance and 80% Qualitative – Discretionary.
3. Deviation from the standard payment schedule of an Incentive Compensation Award based on the smaller amount of the awards relative to other participants in the ICP. We recommend the payment schedule be 50% of any Incentive Compensation Award be paid in the first year and the remaining 50% in the second year, subject always to the other terms of the ICP – including no payments during years of negative Trust Fund Performance and maintaining eligibility under the ICP at the date of payment.

The inclusion of the Investment Operations team and the terms that we propose are consistent with the parameters for other Investment Professionals in the ICP and the goals of the ICP.

Background

Section 2.28 of the ICP plan document defines "Investment Professional" to mean "an ERS employee (other than Leadership Employee) providing high-level, discretionary professional services related to the investment of ERS' assets..." This memo will explain and support how professionals on the Investment Operations team meets the requirements of an Investment Professional as defined in the ICP.

Investment Operations Staff Job Duties and Responsibilities

The Investment Operations team is comprised of highly qualified professionals that have a direct impact on Trust

Fund Performance. Their responsibilities require a high degree of understanding of the workings and complexities of investment markets worldwide. At minimum, applicants are required to have four-year degrees and significant experience within the industry, with preference given to those with experience specifically in middle or back office operations. The first and foremost responsibility of the Investment Operations team is trade settlement and custody of assets. The accomplishment of these functions is inherent in determining Trust Fund Performance and requires discretion regarding the logistics associated with trade settlement and aspects of the custody of Trust Fund assets.

As ERS has increased the number of markets it invests in, the risks of trade failure, and subsequent consequences, has increased exponentially. Trades that fail or are not properly reflected can lead portfolio managers to make investment decisions that impact the Trust Fund Performance. We are currently settling trades in 42 markets versus 20 markets in 2009. Most of the expansion has been into emerging markets. Each member of the Investment Operations team must be a subject matter expert in the trading and settlement practices of these markets to prevent consequences with negative impact on Trust Fund Performance. For example, failing a trade in the Taiwan market can lead to suspension of ERS' trading privileges for up to five years. Differences in time zones further complicate meeting settlement deadline requirements in these markets so the ERS Investment Operations team monitors trading activity from home at night as needed. ERS' custodian and sub-custodians work with ERS to help provide background on different market practices; however, each member of the Investment Operations team has to study and learn what is applicable to ERS and use a range of discretion in handling the aspects of the trade settlement for each trade performed.

By auditing the trade programs on a daily basis in both domestic and international markets, Investment Operations ensures that trades are not settled with terms other than those agreed upon between our traders and external brokers or are not properly authorized. This rigorous attention is critical to ensuring the Trust Fund's assets are not subject to unnecessary loss and that other Investment Professionals have accurate data with which to make investment decisions. When reviewed with ERS' prior custodian, it was determined that the trade settlement rate for ERS is 3-4% better than average rate for the custodian's other similar clients. This metric not only speaks well of the Investment Operations team but also focuses on supporting ERS' cost-savings and industry reputation.

One of the Investment Operations team's responsibilities for the custody and safekeeping of Trust assets is to review corporate actions notices to evaluate the impact to the Trust Fund and the appropriate action, if needed. The Investment Operations team acts as the primary gatekeeper to make sure other Investment Professionals do not miss relevant deadlines that could result in lost opportunities for the fund as well as help facilitate further actions, if necessary. Investment Operations works closely with ERS Legal by providing technical background to help analyze these corporate actions.

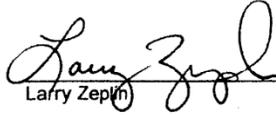
Recommendation Aligned with ICP Goals

Attracting and retaining key employees in a cost-effective manner is one of the primary goals of the ICP. ERS faces recruitment and retention challenges because most local peers include their operations staff in their incentive compensation programs, such as Teacher Retirement System and the Permanent School Fund. An example of the challenge faced occurred when recruiting for the current two vacancies on the team. One individual retired and the second left for an operations position, classed one step *below* ERS, with a salary that was 17% more than ERS and that was included in that agency's incentive compensation. During the process of hiring for these vacancies, each position received upwards of 10 candidates, but virtually none even met the minimum requirements of the job description. The few who met the minimum requirements still lacked the high level of experience and industry knowledge expected. We believe without having the option to offer participation in the ICP to recruits, we face a handicap in attracting high quality investment professionals. We understand another important goal of the ICP is to promote teamwork. Investment Operations team members perform duties day-in-and-day-out that make them an integral part of the Investment team and impact Trust Fund Performance

July 31, 2012
Page 3

and ERS' fiduciary duty. The Investment Operations team inclusion in the ICP would appropriately recognize their contributions and continue to promote high quality outcomes as well as ERS' strategic and operational goals. We appreciate your favorable consideration of this recommendation.

APPROVED
 NOT APPROVED


Larry Zepf 8/22/12
Date


Ann S. Bishop 8/28/12
Date

ERS

EMPLOYEES RETIREMENT
SYSTEM OF TEXAS

200 E. 18TH STREET, AUSTIN, TEXAS 78701 | P. O. BOX 13207, AUSTIN, TEXAS 78711-3207 | (512) 867-7711 | (877) 275-4377 TOLL-FREE | WWW.ERS.STATE.TX.US

INTEROFFICE MEMORANDUM

DATE: July 27, 2012
TO: Ann S. Bishop, Executive Director
Larry Zeplin, Chief Operating Officer
THROUGH: Jacqueline Johnson, Deputy Executive Director of Investments
FROM: Investments Administrative Team
SUBJECT: Inclusion in ERS' Investments Incentive Compensation Plan (ICP)

When we met with you in May, you requested that we justify the inclusion of the Investments administrative team in ERS' Investments Incentive Compensation Plan (ICP). Thank you for giving us the opportunity to express our thoughts on inclusion in this program.

Items 1.1 of the Incentive Compensation Plan states that "The Plan is intended to provide incentives to those participating employees who excel in carrying out the strategic performance priorities established by the Board and achieve the highest level of performance on behalf of ERS and its members, retirees, and beneficiaries. Specifically, the Plan is designed to:

- (a) Provide participating employees with the opportunity to earn reasonable incentive compensation for leadership and outstanding performance based on Trust Fund Performance as well as performance based of respective asset classes, portfolios and individual contributions;
- (b) Encourage sustained levels of outstanding investment performance prudently achieved without undue risk;
- (c) Promote teamwork among employees;
- (d) Support ERS' strategic and operational goals;
- (e) Attract and retain key employees in a cost-effective manner; and;
- (f) Focus employees on high quality outcomes"

Because we work directly with the Investments professionals in our division on a daily basis, we believe that we are an integral part of the Investments team. The employees that we support are responsible for the fund's performance. Exhibits A and B detail the specific ways in which we support performance through our job duties.

In addition to promoting teamwork, the ICP has been revised and made a priority in order to support employee retention. The McLagan study that was completed in 2010 indicated that of the funds they surveyed, only 20% included their administrative or operations staff in their ICP. However, the two pension funds in Austin with which ERS is frequently compared, the Teacher Retirement System and the Permanent School Fund, do, in fact, include their administrative and operations staff in their incentive programs.

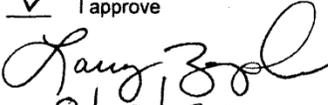
While we do not select specific investments for the fund, our knowledge of investments and the trading process contributes to the efficient and accurate processing of the Investments staff's chosen trades (details in Exhibit A). We also do not have specific education in finance or investments, but the on-the-job training we have received in the years worked here has given us the ability to catch problems that an administrative employee from another division (or who was hired from the outside) would not recognize without extensive training. In this way, we affect the fund's performance.

We all work diligently to take as many administrative burdens from the Investments' staff as possible, in order for them to have time to research stocks and choose appropriate investments for ERS. Please review Exhibit B for a listing of the administrative tasks that we perform so that the Investments staff can spend their time on what they are trained and educated to do. However, if we understand that the goal of the ICP is to promote teamwork and employee retention consistent with other ICP Plans in the area, then we would urge you to consider our inclusion

Memo RE: Inclusion in the ERS' Investments Incentive Compensation Plan (ICP)
July 27, 2012
Page 2

in the ICP. Whatever the outcome, our hope is that we are viewed as integral to Investments because of our unique training and dedication to supporting the Trust and Investments staff.

We appreciate that you have taken the time to consider our inclusion in ERS' ICP and we look forward to hearing from you.

✓ I approve

8/22/12

Larry Zeplin

✓ I approve


Ann S. Bishop

8/28/12

Date

Administrative Role in Processing Trades

The administrative staff of the Investments Division impacts fund performance by our direct involvement in processing trades. Each of the administrative staff is required to complete a certain percentage of trades each month. Our job descriptions say: "Prepares trades for signatures and inputs into the trading system." The detailed process can be quite time consuming and requires extensive training. ERS administrative staff assists in the completion of approximately 70 trades per month.

When a trade is received the administrative staff:

1. Enters into the trade log as are times for each segment of the trade process.
2. Checks name on the trade to see if they are in the universe or not and who will write the memo for the trade.
3. Distributes copies of the trade to the person(s) who will write the memos (just finding someone to write a trade can be a challenge).
4. Checks memos for accuracy – buys vs. sells, correct ticker and amounts to be traded, signatures.
5. Checks names against the share blocking list, Iran and Sudan lists, and ERS restricted list.
6. Obtains required signature (whether signer is in their office or in a meeting).
7. Fills out cover sheet and takes to Operations for final step in process.
8. Enters time the trade is completed and files.

Then there are the usual issues that can accompany trades, like:

1. Problems receiving faxes/emails where phone calls must be made to trade originators to get the information we need.
2. Read and determine if justification is adequate language.
3. Errors in the trade paperwork, which again requires contact with trade originators to get correct information.
4. If a name is found on one of the "Shareblocking, Socially Constrained or Restricted Lists, additional action must be taken, depending on the problem:
 - a. Shareblocking - Contact internal PM to decide if shares should be recalled (proxy votes). Notify proxy service to recall and verify confirmation of recall or monitor the end of the shareblocking period and notify trading desk to hold until the end date; follow up with email that shareblocking has ended and stock free to trade.
 - b. Socially Constrained – Must make sure the Analyst or PM attaches a memo to the trade that states why another stock of equal or lesser value cannot be obtained.
 - c. Restricted List – Alert the Analyst or PM that the stock cannot be purchased and have them resubmit and updated trade list.
5. Some trades have follow up actions and paperwork to be performed
 - a. Internal Transfer of securities between portfolios.
 - b. IPO – Request from Traders and file documentation on number of shares received or not in the offering.

Administrative Tasks

The administrative team reduces exposure to trade errors and audit issues as well as allowing the remainder of the division to focus on investment research. Some investment division team members do the research, other members participate in the execution of trades, but it takes the effort of all team members, including the administrative team, to ensure the best possible fund performance.

Without the administrative team, Analysts and Portfolio Managers would also spend less time focused on the fund and they would need to significantly increase the number of hours in their workweek in order to do the day-in and day-out duties of the administrative team such as:

- Contact advisors re: trade issues/errors;
- Obtain approval signature for trades;
- Vet brokers;
- Book travel;
- Prepare agendas and minutes for BOT and IAC;
- Facilitate meals for BOT and IAC;
- Input Clarity System data;
- Audit leave accounting records;
- Maintain filing systems;
- Prepare requisitions;
- Coordinate schedules for group meetings;
- Update policies and procedures;
- Facilitate special events;
- Keep office machines functioning;
- Reconcile travel expenses;
- Schedule meetings and conference rooms;
- Coordinate assistance from IS team;
- Order office supplies.



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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Interoffice Memorandum

DATE: August 22, 2012
TO: Ann S. Bishop
FROM: Larry Zeplin
SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals –
██████████

I respectfully request that ██████████, General Counsel and Chief Compliance Officer, be considered an Investment Professional for purposes of eligibility for and addition to the Incentive Compensation Plan for Key Investments Professionals and Leadership Employees (ICP). The ICP defines "Investment Professional" to mean "an ERS employee (other than a Leadership Employee) providing high-level, discretionary professional services related to the investment of ERS' assets, as determined by the Executive Director, and who serves in one of the positions listed in Appendix A; provided, however, for purposes of this Plan, an employee may not be an Investment Professional and a Leadership Employee at the same time."

██████████'s job description, and the high-level professional investment-related discretionary legal services that ██████████ has been performing since 2008, includes the following responsibilities:

- Performs advanced professional and complex legal work, advice and counsel involving regular contact with the Executive Director and Deputy Executive Director of Investments as well as with the legal staffs of the investment advisors, global custodian and other third party firms contracting with the Investments Division.
- Interprets, reviews and supervises negotiations of contracts and other legal documents, including limited partnerships and related documents involving private equity and real estate-related investments, investment advisors, including the development of requirements, specifications and contracts for investment and securities-related projects and other projects as requested.
- Advises and drafts policies and documents in connection with the management and investment of ERS funds; may counsel ERS staff on employment, securities and contract law; and may advise ERS on fiduciary, alternative investments and related issues.

██████████ has and will continue to exercise ██████████ managing the negotiations of investment contracts, and ██████████ has and will continue advising ERS executive management and Investments Division management regarding fiduciary duty, investment compliance, federal and state securities and investment-related laws and regulations and related contract matters.

Ms. Ann Bishop
 August 22, 2012
 Page 2

Providing legal advice and support to and on behalf of the Investments Division is: a critical function of the high-level, discretionary job responsibility of [REDACTED], clearly related to the investment of ERS' assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS' assets. [REDACTED] also provides crucial legal support to the Investments Division through [REDACTED] role as Chief Compliance Officer.

I also propose the need for a primarily qualitative measure to be utilized for [REDACTED] performance goals, with a smaller percentage to be used as a quantitative measure, due to the nature of providing legal services. The nature of the contracts and legal support is outside the control of [REDACTED] and [REDACTED] staff, and is also an inappropriate way to measure the effectiveness of providing legal services. It is more appropriate to assess the quality of the legal services being provided in order to determine whether or not the employee is exceeding [REDACTED] job performance standards.

Please see the chart below for specific recommendations supporting the awards for which I am requesting that [REDACTED] be eligible:

Name	Title	Date of Hire	Effective Date of Plan Eligibility	Current Salary	Performance Goals	Percent of Award
[REDACTED]	General Counsel and Chief Compliance Officer	07/28/1997	09/01/2012	\$195,999.96	75% Qualitative-Discretionary 25% Total Trust Fund Performance	50-65%

AB Given the level of responsibility and oversight that [REDACTED] has undertaken in connection with [REDACTED] provision of legal and compliance efforts for the Investments Division, I am requesting that [REDACTED] "Maximum Incentive Award Percentage," as defined in the ICP, be 65%. *Keep as range*

I am requesting that this memo serve to approve [REDACTED] for participation in the plan, based on the foregoing recommendations, for the 2013 Plan Year.

I Concur:

Larry Zepf
 Chief Operating Officer

8/22/12
 Date

Approved:
w/ change above

Ann S. Bishop
 Executive Director

8/28/12
 Date

[Handwritten Signature]

FY13 Individual Performance Goals and Financial Impact

LEGAL
 Name: [REDACTED]
 Position: General Counsel and Compliance Officer
 Hire: 07/28/1997

Performance Goals	Performance Metrics				Max Incentive Award	Benchmark/Notes
	Sub-Goal Weight	Primary Goal Weight	Mid-Level Award	Incentive Award		
Relative Performance - Global Composite - One Year	25%	25%	0.35		\$105,000.00 determined To be	Excess Return Over Policy Benchmark - One Year - Basis Points (Note: the maximum level represents the target excess return for 2013. Exceeding Job Performance Standards (see Performance Plan & Evaluation form))
Investments Operations Program - Discretionary - One Year	25%	25%				
Total One Year	100%	100%				
Relative Performance - Global Composite - Three Year	25%	25%			\$0-\$25K	Excess Return Over Policy Benchmark - Three Year - Basis Points (Note: the maximum level represents the target excess return for 2013. Exceeding Job Performance Standards (see Performance Plan & Evaluation form))
Investments Operations Program - Discretionary - Three Year	25%	25%				
Total Three Year	100%	100%	0%			
Relative Performance - Global Composite - Five Year	25%	25%			\$0-\$25K	Excess Return Over Policy Benchmark - Five Year - Basis Points (Note: the maximum level represents the target excess return for 2013. Exceeding Job Performance Standards (see Performance Plan & Evaluation form))
Investments Operations Program - Discretionary - Five Year	25%	25%				
Total Five Year	100%	100%	0%			



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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Interoffice Memorandum

DATE: August 22, 2012 (revised from previously submitted memo June 13, 2012)
TO: Ann S. Bishop
THROUGH: Larry Zeplin
FROM: Paula A. Jones *PAJ*
SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals – [REDACTED]

I respectfully request that [REDACTED], Assistant General Counsel, Investments and Securities, be considered an Investment Professional for purposes of eligibility for and addition to the Incentive Compensation Plan for Key Investments Professionals and Leadership Employees (ICP). The ICP defines "Investment Professional" to mean "an ERS employee (other than a Leadership Employee) providing high-level, discretionary professional services related to the investment of ERS' assets, as determined by the Executive Director, and who serves in one of the positions listed in Appendix A; provided, however, for purposes of this Plan, an employee may not be an Investment Professional and a Leadership Employee at the same time."

[REDACTED]'s job description, and the high-level professional investment-related discretionary legal services that [REDACTED] has been performing since 2008, includes the following responsibilities:

- Performs advanced professional and complex legal work, advice and counsel involving regular contact with the General Counsel, Executive Director, Deputy Executive Director of Investments . . . as well as with the legal staffs of the investment advisors, global custodian . . .
- Drafts, interprets, reviews and negotiates contracts and other legal documents, including limited partnerships and related documents involving private equity and real estate-related investments, investment advisor, . . . involving the development of requirements, specifications and contracts for investment and securities-related projects and other projects as requested.
- Advises and drafts documents in connection with the management and investment of ERS funds; may counsel ERS staff on employment, securities and contract law; and may advise ERS on alternative investments and related issues.

[REDACTED] has and will continue to exercise [REDACTED] discretion in drafting, reviewing and negotiating private placement memoranda, limited partnership agreements and related contracts, and [REDACTED] has and will continue advising ERS executive management and Investments Division management regarding investment compliance, federal and state securities and investment-related laws and regulations and related contract matters.

Providing legal advice and support to and on behalf of the Investments Division is: a critical function of the high-level, discretionary job responsibility of [REDACTED], clearly related to the investment of ERS' assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS' assets. [REDACTED] also provides crucial legal support to the TexaSaver 401(k) and 457 programs, and [REDACTED] experience as a CPA and auditor has proven to be invaluable for ERS.

I also propose the need for a primarily qualitative measure to be utilized for [REDACTED]'s performance goals, with a smaller percentage to be used as a quantitative measure, due to the nature of providing legal services. The number and/or dollar amount of the contracts is outside the control of the attorney, and is also an inappropriate way to measure the effectiveness of providing legal services. It is more appropriate to assess the quality of the legal services being provided in order to determine whether or not the employee is exceeding [REDACTED] job performance standards.

Please see the chart below for specific recommendations supporting the awards for which I am requesting that [REDACTED] be eligible:

Name	Title	Date of Hire	Effective Date of Plan Eligibility	Current Salary	Performance Goals	Percent of Award
[REDACTED]	Investments and Securities, Attorney	01/07/08	09/01/2012	\$151,000	75% Qualitative-Discretionary 25% Total Trust Fund Performance	50-65%

AB Given the additional responsibilities that [REDACTED] has undertaken in connection with [REDACTED] provision of high-level investment-related legal services, as well as [REDACTED] CPA and auditor credentials that exceed the requirements for an Assistant General Counsel, I am requesting that [REDACTED]'s "Maximum Incentive Award Percentage," as defined in the ICP, be 65%. *Keep as a range*

I am requesting that this memo serve to approve [REDACTED] for participation in the plan, based on the foregoing recommendations, for the 2013 Plan Year.

I Concur:

Larry Zepher

 Chief Operating Officer

8/22/12

 Date

Approved:
w/ change above

D. S. Bishop

 Executive Director

8/28/12

 Date

██████████
 HIRE: 01/07/08
 Investments and
 Securities, Attorney

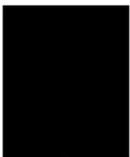
10.65%
 To be
 \$151,000.00 determined

Relative Performance - Global Composite - One Year	23%	0.35
Investments Operations Program - Discretionary - One Year	75%	
Total One Year	100%	100%
Relative Performance - Global Composite - Three Year	23%	
Investments Operations Program - Discretionary - Three Year	75%	
Total Three Year	100%	0%
Relative Performance - Global Composite - Five Year	23%	
Investments Operations Program - Discretionary - Five Year	75%	
Total Five Year	100%	0%

Excess Return Over Policy Benchmark - One Year - Basis Point (Note: the maximum level represents the same excess return for 2013) Exceeding 300 Performance Standards (see Performance Plan & Evaluation form)

Excess Return Over Policy Benchmark - Three Year - Basis Point (Note: the maximum level represents the same excess return for 2013) Exceeding 300 Performance Standards (see Performance Plan & Evaluation form)

Excess Return Over Policy Benchmark - Five Year - Basis Point (Note: the maximum level represents the same excess return for 2013) Exceeding 300 Performance Standards (see Performance Plan & Evaluation form)





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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Interoffice Memorandum

DATE: August 22, 2012 (revised from previously submitted memo June 13, 2012)
TO: Ann S. Bishop
THROUGH: Larry Zeplin
FROM: Paula A. Jones *PAJ*
SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals –
[REDACTED]

I respectfully request that [REDACTED], Assistant General Counsel, Investments and Securities, be considered an Investment Professional for purposes of eligibility for and addition to the Incentive Compensation Plan for Key Investments Professionals and Leadership Employees (ICP). The ICP defines "Investment Professional" to mean "an ERS employee (other than a Leadership Employee) providing high-level, discretionary professional services related to the investment of ERS' assets, as determined by the Executive Director, and who serves in one of the positions listed in Appendix A; provided, however, for purposes of this Plan, an employee may not be an Investment Professional and a Leadership Employee at the same time."

[REDACTED]'s job description, and the high-level professional investment-related discretionary legal services that [REDACTED] has been performing since 2008, includes the following responsibilities:

- Performs advanced professional and complex legal work, advice and counsel involving regular contact with the General Counsel, Executive Director, Deputy Executive Director of Investments . . . as well as with the legal staffs of the investment advisors, global custodian . . .
- Drafts, interprets, reviews and negotiates contracts and other legal documents, including limited partnerships and related documents involving private equity and real estate-related investments, investment advisor, . . . involving the development of requirements, specifications and contracts for investment and securities-related projects and other projects as requested.
- Advises and drafts documents in connection with the management and investment of ERS funds; may counsel ERS staff on employment, securities and contract law; and may advise ERS on alternative investments and related issues.

[REDACTED] has and will continue to exercise [REDACTED] discretion in drafting, reviewing and negotiating private placement memoranda, limited partnership agreements and related contracts, and [REDACTED] has and will continue advising ERS executive management and Investments Division management regarding corporate governance, federal and state securities and investment-related laws and regulations and related contract matters.

Providing legal advice and support to and on behalf of the Investments Division is: a critical function of the high-level, discretionary job responsibility of [REDACTED], clearly related to the investment of ERS' assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS' assets. [REDACTED] has also provided crucial legal support to the TexasAver 401(k) and 457 programs with regard to the addition of investment products, and [REDACTED] private practice real estate experience has proven to be invaluable for ERS.

I also propose the need for a primarily qualitative measure to be utilized for [REDACTED]'s performance goals, with a smaller percentage to be used as a quantitative measure, due to the nature of providing legal services. The number and/or dollar amount of the contracts is outside the control of the attorney, and is also an inappropriate way to measure the effectiveness of providing legal services. It is more appropriate to assess the quality of the legal services being provided in order to determine whether or not the employee is exceeding [REDACTED] job performance standards.

Please see the chart below for specific recommendations supporting the awards for which I am requesting that [REDACTED] be eligible:

Name	Title	Date of Hire	Effective Date of Plan Eligibility	Current Salary	Performance Goals	Percent of Award
[REDACTED]	Investments and Securities, Attorney	10/27/08	09/01/2012	\$151,000	75% Qualitative-Discretionary 25% Total Trust Fund Performance	50-65%

^B Given the outstanding performance that [REDACTED] has consistently exhibited in connection with [REDACTED] provision of high-level investment-related legal services, I am requesting that [REDACTED]'s "Maximum Incentive Award Percentage," as defined in the ICP, be 55%. *Keep as a range*

I am requesting that this memo serve to approve [REDACTED] for participation in the plan, based on the foregoing recommendations, for the 2013 Plan Year.

I Concur: *Larry Zepher* 8/22/12
 Chief Operating Officer Date

Approved: *A S Bishop* 8/28/12
w/ changes above Executive Director Date

Investments and Securities, Attorney	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985	1984	1983	1982	1981	1980	1979	1978	1977	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964	1963	1962	1961	1960	1959	1958	1957	1956	1955	1954	1953	1952	1951	1950	1949	1948	1947	1946	1945	1944	1943	1942	1941	1940	1939	1938	1937	1936	1935	1934	1933	1932	1931	1930	1929	1928	1927	1926	1925	1924	1923	1922	1921	1920	1919	1918	1917	1916	1915	1914	1913	1912	1911	1910	1909	1908	1907	1906	1905	1904	1903	1902	1901	1900	1899	1898	1897	1896	1895	1894	1893	1892	1891	1890	1889	1888	1887	1886	1885	1884	1883	1882	1881	1880	1879	1878	1877	1876	1875	1874	1873	1872	1871	1870	1869	1868	1867	1866	1865	1864	1863	1862	1861	1860	1859	1858	1857	1856	1855	1854	1853	1852	1851	1850	1849	1848	1847	1846	1845	1844	1843	1842	1841	1840	1839	1838	1837	1836	1835	1834	1833	1832	1831	1830	1829	1828	1827	1826	1825	1824	1823	1822	1821	1820	1819	1818	1817	1816	1815	1814	1813	1812	1811	1810	1809	1808	1807	1806	1805	1804	1803	1802	1801	1800	1799	1798	1797	1796	1795	1794	1793	1792	1791	1790	1789	1788	1787	1786	1785	1784	1783	1782	1781	1780	1779	1778	1777	1776	1775	1774	1773	1772	1771	1770	1769	1768	1767	1766	1765	1764	1763	1762	1761	1760	1759	1758	1757	1756	1755	1754	1753	1752	1751	1750	1749	1748	1747	1746	1745	1744	1743	1742	1741	1740	1739	1738	1737	1736	1735	1734	1733	1732	1731	1730	1729	1728	1727	1726	1725	1724	1723	1722	1721	1720	1719	1718	1717	1716	1715	1714	1713	1712	1711	1710	1709	1708	1707	1706	1705	1704	1703	1702	1701	1700	1699	1698	1697	1696	1695	1694	1693	1692	1691	1690	1689	1688	1687	1686	1685	1684	1683	1682	1681	1680	1679	1678	1677	1676	1675	1674	1673	1672	1671	1670	1669	1668	1667	1666	1665	1664	1663	1662	1661	1660	1659	1658	1657	1656	1655	1654	1653	1652	1651	1650	1649	1648	1647	1646	1645	1644	1643	1642	1641	1640	1639	1638	1637	1636	1635	1634	1633	1632	1631	1630	1629	1628	1627	1626	1625	1624	1623	1622	1621	1620	1619	1618	1617	1616	1615	1614	1613	1612	1611	1610	1609	1608	1607	1606	1605	1604	1603	1602	1601	1600	1599	1598	1597	1596	1595	1594	1593	1592	1591	1590	1589	1588	1587	1586	1585	1584	1583	1582	1581	1580	1579	1578	1577	1576	1575	1574	1573	1572	1571	1570	1569	1568	1567	1566	1565	1564	1563	1562	1561	1560	1559	1558	1557	1556	1555	1554	1553	1552	1551	1550	1549	1548	1547	1546	1545	1544	1543	1542	1541	1540	1539	1538	1537	1536	1535	1534	1533	1532	1531	1530	1529	1528	1527	1526	1525	1524	1523	1522	1521	1520	1519	1518	1517	1516	1515	1514	1513	1512	1511	1510	1509	1508	1507	1506	1505	1504	1503	1502	1501	1500	1499	1498	1497	1496	1495	1494	1493	1492	1491	1490	1489	1488	1487	1486	1485	1484	1483	1482	1481	1480	1479	1478	1477	1476	1475	1474	1473	1472	1471	1470	1469	1468	1467	1466	1465	1464	1463	1462	1461	1460	1459	1458	1457	1456	1455	1454	1453	1452	1451	1450	1449	1448	1447	1446	1445	1444	1443	1442	1441	1440	1439	1438	1437	1436	1435	1434	1433	1432	1431	1430	1429	1428	1427	1426	1425	1424	1423	1422	1421	1420	1419	1418	1417	1416	1415	1414	1413	1412	1411	1410	1409	1408	1407	1406	1405	1404	1403	1402	1401	1400	1399	1398	1397	1396	1395	1394	1393	1392	1391	1390	1389	1388	1387	1386	1385	1384	1383	1382	1381	1380	1379	1378	1377	1376	1375	1374	1373	1372	1371	1370	1369	1368	1367	1366	1365	1364	1363	1362	1361	1360	1359	1358	1357	1356	1355	1354	1353	1352	1351	1350	1349	1348	1347	1346	1345	1344	1343	1342	1341	1340	1339	1338	1337	1336	1335	1334	1333	1332	1331	1330	1329	1328	1327	1326	1325	1324	1323	1322	1321	1320	1319	1318	1317	1316	1315	1314	1313	1312	1311	1310	1309	1308	1307	1306	1305	1304	1303	1302	1301	1300	1299	1298	1297	1296	1295	1294	1293	1292	1291	1290	1289	1288	1287	1286	1285	1284	1283	1282	1281	1280	1279	1278	1277	1276	1275	1274	1273	1272	1271	1270	1269	1268	1267	1266	1265	1264	1263	1262	1261	1260	1259	1258	1257	1256	1255	1254	1253	1252	1251	1250	1249	1248	1247	1246	1245	1244	1243	1242	1241	1240	1239	1238	1237	1236	1235	1234	1233	1232	1231	1230	1229	1228	1227	1226	1225	1224	1223	1222	1221	1220	1219	1218	1217	1216	1215	1214	1213	1212	1211	1210	1209	1208	1207	1206	1205	1204	1203	1202	1201	1200	1199	1198	1197	1196	1195	1194	1193	1192	1191	1190	1189	1188	1187	1186	1185	1184	1183	1182	1181	1180	1179	1178	1177	1176	1175	1174	1173	1172	1171	1170	1169	1168	1167	1166	1165	1164	1163	1162	1161	1160	1159	1158	1157	1156	1155	1154	1153	1152	1151	1150	1149	1148	1147	1146	1145	1144	1143	1142	1141	1140	1139	1138	1137	1136	1135	1134	1133	1132	1131	1130	1129	1128	1127	1126	1125	1124	1123	1122	1121	1120	1119	1118	1117	1116	1115	1114	1113	1112	1111	1110	1109	1108	1107	1106	1105	1104	1103	1102	1101	1100	1099	1098	1097	1096	1095	1094	1093	1092	1091	1090	1089	1088	1087	1086	1085	1084	1083	1082	1081	1080	1079	1078	1077	1076	1075	1074	1073	1072	1071	1070	1069	1068	1067	1066	1065	1064	1063	1062	1061	1060	1059	1058	1057	1056	1055	1054	1053	1052	1051	1050	1049	1048	1047	1046	1045	1044	1043	1042	1041	1040	1039	1038	1037	1036	1035	1034	1033	1032	1031	1030	1029	1028	1027	1026	1025	1024	1023	1022	1021	1020	1019	1018	1017	1016	1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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Interoffice Memorandum

DATE: August 22, 2012 (revised from previously submitted memo June 14, 2012)
TO: Ann S. Bishop
THROUGH: Larry Zeplin
FROM: Paula A. Jones 
SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals –
██████████

I respectfully request that ██████████, Paralegal, Investments and Securities, be considered an Investment Professional for purposes of eligibility for and addition to the Incentive Compensation Plan for Key Investments Professionals and Leadership Employees (ICP). The ICP defines "Investment Professional" to mean "an ERS employee (other than a Leadership Employee) providing high-level, discretionary professional services related to the investment of ERS' assets, as determined by the Executive Director, and who serves in one of the positions listed in Appendix A; provided, however, for purposes of this Plan, an employee may not be an Investment Professional and a Leadership Employee at the same time."

██████████ job description, and the high-level professional investment-related discretionary paralegal services that ██████████ has been performing since 2008 at ERS, includes the following responsibilities:

- Assists in the development, implementation and coordination of an agency-wide alternative investments program for ERS; researches, drafts, evaluates, revises and/or develops policies, procedures, guidelines, processes, systems and forms for the Investments Division.
- Reviews, drafts and revises investments-related contracts; under the supervision of ERS attorneys, directly negotiates with staff of investment advisors and other vendors; completes subscription agreements, know-your-client documentation in foreign jurisdictions, and other private investment documentation.
- Serves as liaison between . . . staff attorneys and Deputy Executive Director of Investments as needed; advises and interacts with the General Counsel and the Executive Director, as needed; provides assistance to attorneys and participates in planning, coordination and execution of transaction closings; manages closing documents and distribution of document sets following deal closings; reviews transaction closing binders to ensure completeness and accuracy.
- Coordinates information gathering from various departments to ensure accuracy of the provisions of deal-related contracts and other legal documents; maintains complex records of a confidential nature; assists with open records requests related to investment contracts and transactions.

Investments and Securities, Paragraph	20-15%	19-14	\$68,250.00	determined
Hint: 100003				
Relative Performance - Global Composite - One Year	10%	0.36		
Investment Operations Program - Discretionary - One Year	92%			Excess Return Over Policy Benchmark - One Year - Basis Points (Note: the maximum level represents the target excess return for 2013) Exceeding 100 Performance Standards (see Performance Plan & Evaluation form)
Total One Year	100%	100%		
Relative Performance - Global Composite - Three Year	10%			Excess Return Over Policy Benchmark - Three Year - Basis Points (Note: the maximum level represents the target excess return for 2013) Exceeding 100 Performance Standards (see Performance Plan & Evaluation form)
Investment Operations Program - Discretionary - Three Year	92%			
Total Three Year	100%	0%		
Relative Performance - Global Composite - Five Year	10%			Excess Return Over Policy Benchmark - Five Year - Basis Points (Note: the maximum level represents the target excess return for 2013) Exceeding 100 Performance Standards (see Performance Plan & Evaluation form)
Investment Operations Program - Discretionary - Five Year	92%	0%		
Total Five Year	100%	100%		



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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Interoffice Memorandum

DATE: July 15, 2013
TO: Ann S. Bishop
THROUGH: Larry Zeplin
FROM: Paula A. Jones 
SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals –
██████████ Pro Rata Participation in PY2013

On April 26, 2013, I requested that ██████████ be approved for participation in the Incentive Compensation Plan (ICP) for Plan Year 2014. Today I received information from Human Resources reflecting ██████████'s eligibility for pro rata participation in the ICP for PY 2013. The ICP defines "Investment Professional" to mean "an ERS employee (other than a Leadership Employee) providing high-level, discretionary professional services related to the investment of ERS' assets, as determined by the Executive Director, and who serves in one of the positions listed in Appendix A; provided, however, for purposes of this Plan, an employee may not be an Investment Professional and a Leadership Employee at the same time."

██████████ job description, and the high-level professional investment-related discretionary legal services that ██████████ has been performing since January, 2013, includes the following responsibilities:

- Performs advanced professional and complex legal work, advice and counsel involving regular contact with the General Counsel, Executive Director, Deputy Executive Director of Investments . . . as well as with the legal staffs of the investment advisors, global custodian . . .
- Drafts, interprets, reviews and negotiates contracts and other legal documents, including limited partnerships and related documents involving private equity and real estate-related investments, investment advisor, . . . involving the development of requirements, specifications and contracts for investment and securities-related projects and other projects as requested.
- Advises and drafts documents in connection with the management and investment of ERS funds; may counsel ERS staff on employment, securities and contract law; and may advise ERS on alternative investments and related issues.

██████████ has and will continue to exercise ██████████ discretion in drafting, reviewing and negotiating private placement memoranda, limited partnership agreements and related contracts, and ██████████ has and will continue advising ERS executive management and Investments Division management regarding investment compliance, federal and state securities and investment-related laws and regulations and related contract matters.

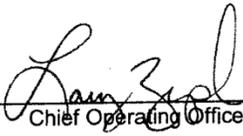
Providing legal advice and support to and on behalf of the Investments Division is: a critical function of the high-level, discretionary job responsibility of [REDACTED], clearly related to the investment of ERS' assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS' assets.

I also propose the need for a primarily qualitative measure to be utilized for [REDACTED] performance goals, with a smaller percentage to be used as a quantitative measure, due to the nature of providing legal services. The number and/or dollar amount of the contracts is outside the control of the attorney, and is also an inappropriate way to measure the effectiveness of providing legal services. It is more appropriate to assess the quality of the legal services being provided in order to determine whether or not the employee is exceeding [REDACTED] job performance standards.

Please see the chart below for specific recommendations supporting the awards for which I am requesting that [REDACTED] be eligible:

Name	Title	Date of Hire	Effective Date of Plan Eligibility	Current Salary	Performance Goals	Percent of Award
[REDACTED]	Investments and Securities, Attorney	01/07/13	02/01/2013	\$140,000	75% Qualitative-Discretionary 25% Total Trust Fund Performance	50-65%

Based on the foregoing, I am requesting that [REDACTED] be approved retroactively for participation in the ICP, on a pro rata basis, for PY 2013 effective February 1, 2013.

I Concur: 
 Chief Operating Officer

7/14/13
 Date

Approved: 
 Executive Director

7/16/13
 Date

FY13 Individual Performance Goals and Financial Impact

Investments and
 Operations, Strategy

15-62%
 7.0%
 \$140,000.00 determined

Effective 02/01/13	Relative Performance - Global Composite - One Year	23%	0.36
	Investments Operations Program - Discretionary - One Year	23%	
	Total One Year	100%	100%
	Relative Performance - Global Composite - Three Year	23%	
	Investments Operations Program - Discretionary - Three Year	100%	0%
	Total Three Year	100%	
	Relative Performance - Global Composite - Five Year	23%	
	Investments Operations Program - Discretionary - Five Year	23%	0%
	Total Five Year	100%	100%

Excess Return Over Policy Benchmark - One Year - Basis Points (Note: the maximum level represents the target excess return for 2013)
 Exceeding Job Performance Standards (see Performance Plan & Evaluation form)

Excess Return Over Policy Benchmark - Three Year - Basis Points (Note: the maximum level represents the target excess return for 2013)
 Exceeding Job Performance Standards (see Performance Plan & Evaluation form)

Excess Return Over Policy Benchmark - Five Year - Basis Points (Note: the maximum level represents the target excess return for 2013)
 Exceeding Job Performance Standards (see Performance Plan & Evaluation form)



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