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An Audit Report on Management Controls at the Office of the Fire Fighters' Pension Commissioner

October 1997

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Key Points of Report

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Overall Conclusion

The Commissioner and Board of Trustees of the Office of the Fire Fighters' Pension Commissioner (Commission) have not demonstrated the ability to establish effective control over critical Commission functions. We believe that external intervention is necessary to establish adequate control over the $20 million Texas Statewide Volunteer Fire Fighters' Retirement Fund. We recommend that state oversight officials consider mandating adequate controls over the critical functions of the Commission.

Key Facts and Findings

- The Commissioner implemented some of the recommendations we made to address control issues identified during the course of this review. However, the Board of Trustees (Board) and Commissioner have a pattern of operating in ways that show inadequate attention to establishing proper controls. The result of this pattern has been that the responsibility for recommending and monitoring effective controls has largely fallen on the auditors.

  The Commission did not establish effective contract administration controls over its investment activities, including controls over contractor selection, contract provisions, contract payment methodology, and contractor oversight. The absence of such oversight constitutes a material weakness in the Commission's overall control environment.

- The Board failed to provide adequate governance and oversight for Commission activities. Failure to disclose business relationships between Board members and the Fund's consultant did not comply with the Board's ethics policy and could give rise to the appearance of a conflict of interest. The Board's approval of changes to critical Commission functions was made without adequate time for deliberation and was based on limited information.

- The Commission did not follow state law, which requires trust funds to transfer uninvested cash to the State Treasury prior to reinvesting it. Transferring cash balances to an account at the State Treasury would also improve control over fee payments to contracted investment providers.

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This audit was conducted in accordance with Government Code, Sections 321.0132 and .0133.

Executive Summary

The Commission Failed to Provide Basic Oversight and Control of Commission Investment Activities

The Commissioner and Board of Trustees of the Office of the Fire Fighters' Pension Commissioner (Commission) have not demonstrated the ability to establish effective control over critical Commission functions:

- During fiscal year 1997, decisions and changes to the Commission's business arrangements exposed the $20 million pension fund (Fund) to unacceptable levels of risk.
- Before fiscal year 1997, our audit work at the Commission had resulted in a record of significant or material control weaknesses. The Commission has generally failed to resolve these serious weaknesses within a reasonable time frame. (See Appendix 2.3.)

Because of this history, we believe that external intervention is necessary to establish adequate control over the Fund. Thus, we recommend that the Legislature consider a range of options for mandating adequate control over the critical functions of the Commission. These options include, but are not limited to, the following:

- Require the Commission to contract with the Employees Retirement System (ERS) for investment consulting, money management, custodian, and investment accounting services. This would bring the Fund under the umbrella of ERS's controls but still allow the Board to govern and oversee the Fund and the Commission's other activities.
- Mandate more effective controls in the Commission's enabling legislation. For example, specify that:
  - The Commissioner's education include course work or prior work experience in the areas of business administration, accounting, or investments
  - The Commission establish a part-time internal audit function
  - The Commission undergo independent regular investment reviews by the Legislature, and/or submit reports for the Legislature that include a study of the potential

The Committee of Sponsoring Organizations of the Treadway Commission has defined internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations, including safeguarding of resources
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Internal control can only be judged effective if the board and management have reasonable assurance that:

- They understand the extent to which the entity's operating objectives are being achieved.
- Published financial statements are being prepared reliably.
- Applicable laws and regulations are being complied with.

The executive director is ultimately responsible for internal control and should assume "ownership" of the system. Management is accountable to the board, which provides governance, guidance, and oversight. Effective board members are objective, capable, and inquisitive.

Auditors, bringing an independent and objective view, contribute by providing useful information to management and the board in carrying out their responsibilities for control. However, auditors are not responsible for, nor are they part of, the entity's internal control systems.

impact of changes made in its contracted investment service arrangements on controls over the process

- The Commission be required follow to the General Services Commission's competitive bidding process for future investment consulting service contracts; currently, investment consulting contracts are exempted from competitive bidding rules.

- Contracts contain provisions that give auditors access to information relating to the pension fund and the ability to audit such information as necessary

The Commission Did Not Establish Effective Contract Administration Controls Over Its Investment Activities

The Commission did not establish effective contract administration controls over its investment activities, including controls over contractor selection, contract provisions, contract payment methodology, and contractor oversight. As a result, excessive levels of authority over Commission funds were concentrated in a consultant working in the private sector (Consultant). While there is no evidence that the Consultant misused this authority, a properly functioning system of internal controls requires that the Board and the Commissioner maintain an adequate degree of oversight for investment activities. The absence of such oversight constitutes a material weakness in the Commission's overall control environment.

The Commission failed to ensure that contracting procedures for new custodial and investment consulting services conformed to good business practices and state requirements, such as the General Services Commission's purchasing rules. The Commission delegated the responsibility of conducting the selection process for a new custodian of funds to the Consultant who, at that time, had no contractual relationship with the Commission. The Board approved plans for changing the Commission's investment consulting and custodial firms without adequate time for deliberation and with limited information.

In addition, the Commissioner did not ensure that contract provisions specified appropriate control procedures to provide reasonable assurance that the Commission's objectives would be achieved. Such control procedures generally pertain to safeguarding the Fund; segregation of duties between the Consultant, the Money Managers, and the Custodian of funds; transaction authorization; proper investment valuation; and investment reporting. They also ensure that investment-related processes comply with applicable laws and regulations and provide access to records for audit purposes. For example, the Consultant's contract allowed him to calculate his fees based on the market value of the Fund and debit the Commission's accounts for payment. This contract provision did not comply with the Commission's established control procedures, which require invoices to be received and approved by the Commissioner before the Custodian is authorized to release funds for payment. A payment of $26,289 was automatically debited on November 1, 1996, without prior approval of the Commissioner.

The Commission did not use other controls, available through its contractual relationship with an accounting firm, to provide some compensation for the lack of formal contractual control provisions.

Executive Summary

The Board Failed To Provide Adequate Governance and Oversight for Commission Activities

Failure to disclose business relationships between Board members and the consultant did not comply with the Board's ethics policy. Currently, the Board Chair and one member of the Board's Investment Committee are clients of the investment consulting company established by the Consultant. These Board members voted to award a contract to the Consultant's company without disclosing their business relationships with the company. This did not comply with the Board's ethics policy and could give rise to the appearance of a conflict of interest.

Ensure Compliance With State Law Requiring the Transfer of Uninvested Cash to the State Treasury

At March 31, 1997, the Fund held $948,605 in money market funds. The Commission did not follow state law, which requires trust funds to transfer uninvested cash to the State Treasury prior to reinvesting it.

Summary of Objective and Scope

Our audit objective was to follow up on issues identified during the small agency management control follow-up audit of the Office of the Fire Fighters' Pension Commissioner in April 1996.

Prior to the release of our management letter in September 1996, the Commission experienced several changes in its contracted investment services. In lieu of releasing the report, we discussed all recommendations with the Commissioner and made clear our intent to follow up on the recommendations as part of the fiscal year 1996 annual financial opinion audit. (See Appendix 2.2 for details.)

Scope Limitation

The scope of our review was limited by a difficulty in obtaining access to information from outside contractors. This caused unnecessary delay in the completion of audit fieldwork and made certain audit issues more difficult to examine and resolve. We recommend that the Commission include provisions in future contracts that expressly authorize auditors to review contractor records and information relating to the management of the Fund.

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Section 1:

The Commission Has Failed to Provide Basic Oversight and Control of Commission Investment Activities

The Commission implemented some of the recommendations we made to address control issues identified during the course of this review. However, the Board and Commissioner have a pattern of operating in ways that show inadequate attention to establishing proper controls. The result of this pattern has been that the responsibility for recommending and monitoring effective controls has largely fallen on the auditors.

Section 1-A:

The Commission Did Not Establish Effective Contract Administration Controls Over Its Investment Activities

The Commission did not establish effective contract administration controls over its investment activities, including controls over contractor selection, contract provisions, contract payment methodology, and contractor oversight. As a result, excessive levels of authority over Commission funds were concentrated in a consultant working in the private sector (Consultant). While there is no evidence that the Consultant misused this authority, a properly functioning system of internal controls requires that the Board and the Commissioner maintain an adequate degree of oversight for investment activities. The absence of such oversight constitutes a material weaknesses in the Commission's overall control environment.

The Commission failed to ensure that contracting procedures for new custodial services and investment consulting services conformed to good business practice and state requirements: (See Appendix 2.1 for a chronology of events.)

- The Commission delegated the responsibility of conducting the selection process for a new custodian of funds to a consultant who, at that time, had no contractual relationship with the Commission. Without a contract defining the Consultant's responsibilities, the Commission had no mechanism to ensure that the duties performed were in the best interest of the Commission or in compliance with state requirements and Commission policies.

- The Commission did not establish selection and bid evaluation criteria. Without such criteria the Commission cannot ensure that a fair and impartial process was used in awarding contracts for services.

- The Commission did not retain copies of proposals or evaluation documents related to the custodian selection process. Documents related to the selection of a contractor may be subject to open records and should be maintained by the Commission.

- The Commission did not go through a process to ensure that the Commission's contracted investment consulting services were the most beneficial and cost effective services available to the pension fund (Fund). Although investment consulting contracts are exempted from the consulting services provisions of Government Code, Sections 2254.021 through .040, the State Auditor's Office recommended in July 1996 that the Commission conduct a request for proposal (RFP) before awarding the contract. An RFP process would have provided the Commission with the detailed information necessary to evaluate the services and associated costs proposed by various consultants.

- The Commissioner executed an investment consulting contract and a custodial services contract without prior review by the Board or legal staff. Review by the Board helps ensure that contract provisions are sufficient enough for the Board to meet its fiduciary responsibility for overseeing investment activities. Review by legal counsel before executing a contract helps ensure that contract provisions comply with state law and that the Commission's interests are protected.

- In August 1996, the Commissioner prevented its investment consulting/custodial firm (Investment Firm) from continuing to perform services under the contract it had with the Commission. The Commissioner instructed the Investment Firm that it was not authorized to perform work for the Commission until further approval by the Board was received in September 1996. Thus, the Commission's accounts had no authorized supervision for 36 days although a contract with the Investment Firm was still in place.

  As a result of this instruction, the Commission's Contract Accountant was unable to receive reports from the Investment Firm critical to investment reconciliation activities. The Investment Firm was also unable to present a periodic investment report at the September Board meeting. Instead, the Commissioner allowed the Consultant to present this report even though he was no longer employed with the Investment Firm and had no contractual relationship with the Commission.

Available documentation does not indicate that the custodian contract selection process conformed to state requirements:

- Proposals were not solicited from firms on the General Services Commission's master bidders list for custodial services.

- Other competitive bidding requirements of the General Services Commission were not followed, such as ensuring that the evaluation process was adequately documented. This documentation is required so that bid results can be retabulated if contract awards are questioned.

- Historically underutilized business provisions of the General Services Commission's requirements and the Board's ethics policy were not followed.

Section 1-B:

The Commissioner Did Not Ensure That Contract Provisions Specified Appropriate Control Procedures

Investment Consultant:
- Money manager searches
- Performance reporting
- Money manager evaluation
- Asset allocation advice
- Investment policy advice
- Assist in review, evaluation and fee negotiation for all providers

Investment Custodian:
- Maintain fund accounts
- Transaction recording
- Trading desk
- Payment of fees

Money Manager (Investment Advisor):
- Buy and sell securities and stocks according to the board's investment policy

The Contract Provisions did not establish proper segregation of duties between the Consultant, the Money Managers, and the Custodian of funds. The Commissioner delegated responsibility for critical management activities to a consultant. This delegation resulted in a lack of appropriate segregation of duties between the Consultant, the Money Managers, and the Custodian of funds. The following are examples of these management activities:

- Establishing the Commission's accounts with a new custodial firm - The custodian arrangement included a trust company (Custodian) and a subcontractor (Brokerage Firm). The Brokerage Firm actually held the Commission's funds. The Commissioner and the Board were initially unaware that the Brokerage Firm was a part of the Commission's business arrangement. For a period of at least five months, the Commissioner did not fully understand the relationship. In a February 4, 1997, letter to the Consultant, the Commissioner expressed confusion about the Custodian/ Brokerage Firm business arrangement. The Brokerage Firm also indicated that it mistakenly assumed the Commission's accounts were to be handled in the same manner as other accounts it handled for the Consultant.

- Establishing Consultant payment authorization on the Commission's account - Establishing payment authorization designates to the Custodian/Brokerage Firm which entities or individuals are authorized to approve the payment of expenditures such as accounting and money manager fees. Such authorization allowed the Consultant to automatically debit and credit the Commission's account without prior approval by the Commissioner. Consultant fees totaling $26,289.40 were debited from the Commission's accounts on November 1, 1996.

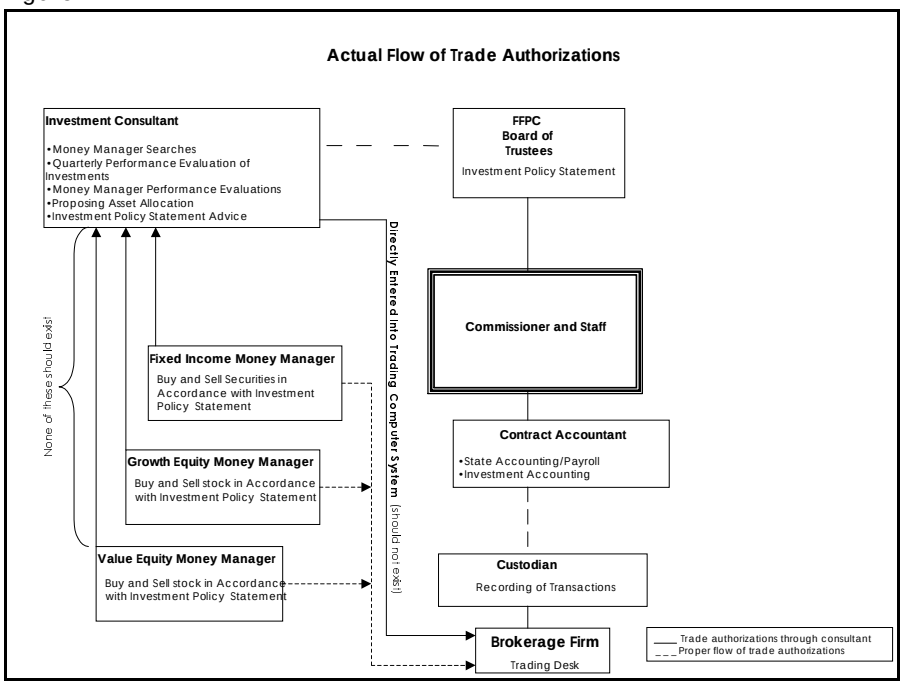
  The Commission's contract with its Custodian was in direct conflict with provisions outlined in the Consultant's contract with the Commission. The Custodian's contract stated that the Custodian shall hold, invest, disburse, or otherwise dispose of property in the account or its proceeds only upon written authorization by the Trustees or the Commissioner. However, a provision in the Consultant's contract allowed the Consultant to automatically debit and credit the Commission's accounts.

The Commissioner was not aware of the $26,289.40 fee transaction until January 28, 1997. Neither the Commission nor its Contract Accountant received an invoice prior to the debiting of the accounts. In March 1997, after auditors brought this issue to the attention of the Commissioner, the Commissioner instructed the Custodian/Brokerage Firm to designate her as the only person that could approve expenditure transactions.

- Directing the flow of invoices for approval and payment - Money manager fee invoices were directed to the Consultant for approval and payment instead of the Commission. One of the three Money Managers began invoicing the Consultant's company (instead of the Investment Firm under contract at that time or the Commission) for payment of quarterly fees in July 1996. This was two months before the Consultant's company was formally hired by the Board.

- Directing the flow of trading authorizations - Money Manager trading authorizations were reported to the Consultant instead of being directed to the Custodian. The Consultant electronically entered all accepted trading authorizations into the computer system at the Brokerage Firm's trading desk. The Consultant told the Commissioner that this was done to achieve best trade execution by bundling trades. However, the Brokerage Firm's trading desk also has the ability to bundle trades to achieve best execution. Trade execution and entering trade authorizations are not listed services in the Consultant's contract.

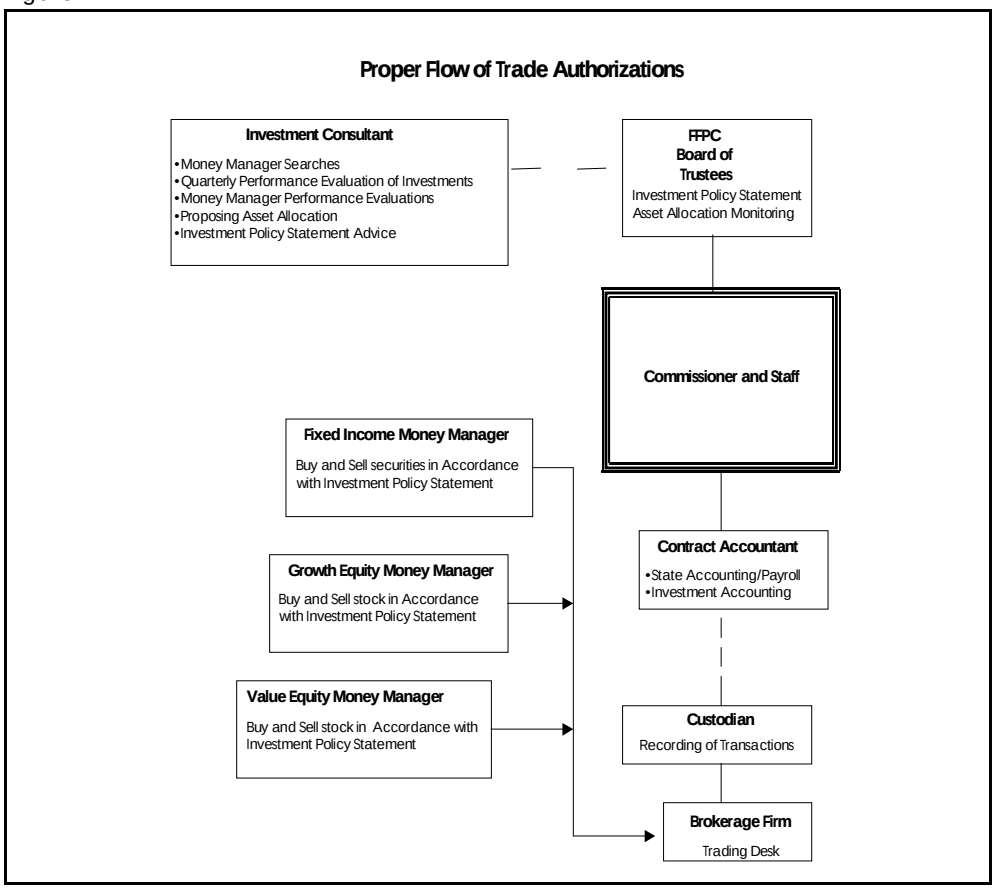
Figure 1



Good investment control procedures require Money Managers to execute trading authorizations directly to the trading desk of the Custodian to ensure proper segregation between the Consultant and the Money Managers.

All independent monitoring of trading activity by the Consultant to prepare money manager performance evaluations should be done after the fact; that is, after the Money Managers have executed the trades directly with the Custodian's trading desk and executed transaction data is available for viewing. This ensures that a consultant responsible for evaluating the investment performance of the Money Managers can independently evaluate the results of trading activities.

Figure 2



The Commission did not use other controls, available through its contractual relationship with an accounting firm, to provide some compensation for the lack of formal contractual control provisions:

- The Commissioner did not delegate the responsibility for setting up the Commission's accounts at the Custodian/Brokerage Firm to the Contract Accountant. Since the Contract Accountant was responsible for maintaining

the books of the Commission, record keeping would have been simplified if the Contract Accountant had been allowed to directly inform the Custodian/Brokerage Firm of all Commission policies and procedures for fee payments and trading activity.

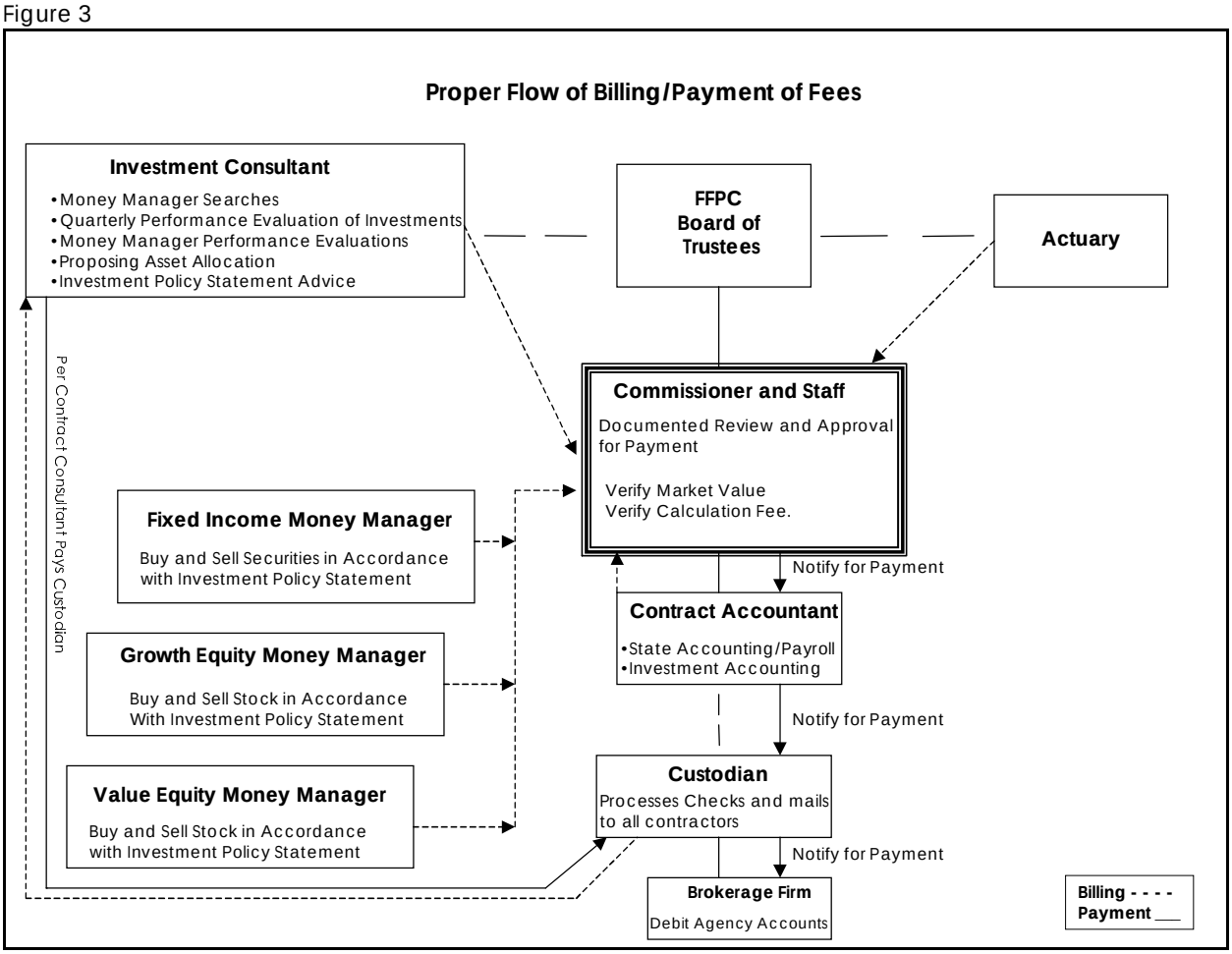
- The Commissioner did not ensure that her staff or the Contract Accountant recalculated bills to make sure they were correct, verified the accuracy of market values used as a basis for fee calculation, or ensured that consistent market values were used by the four entities calculating bills based on market values. These are important control procedures to ensure that contractor fees are based on accurate market valuations. During the course of the audit, we obtained the details of the fee calculation from the Consultant's company and provided the Commission with this information.

The Commission did not establish effective controls over contract payments:

- Invoices were not always sent to the Commission. As a result, double-billing of fees occurred and was not detected by the Commissioner or the Contract Accountant in the normal course of operations. The Commissioner approved two fee invoices from the Money Manager for the same quarter (first quarter of 1997). Apparently, a fee invoice was sent both to the Custodian and to the Consultant who both forwarded it to the Commission for payment authorization. The Commissioner was not aware that the Custodian had actually debited the Commission's account prior to obtaining her approval. The Consultant recognized and resolved this overpayment by negotiating with the Money Manager prior to notifying the Commissioner.

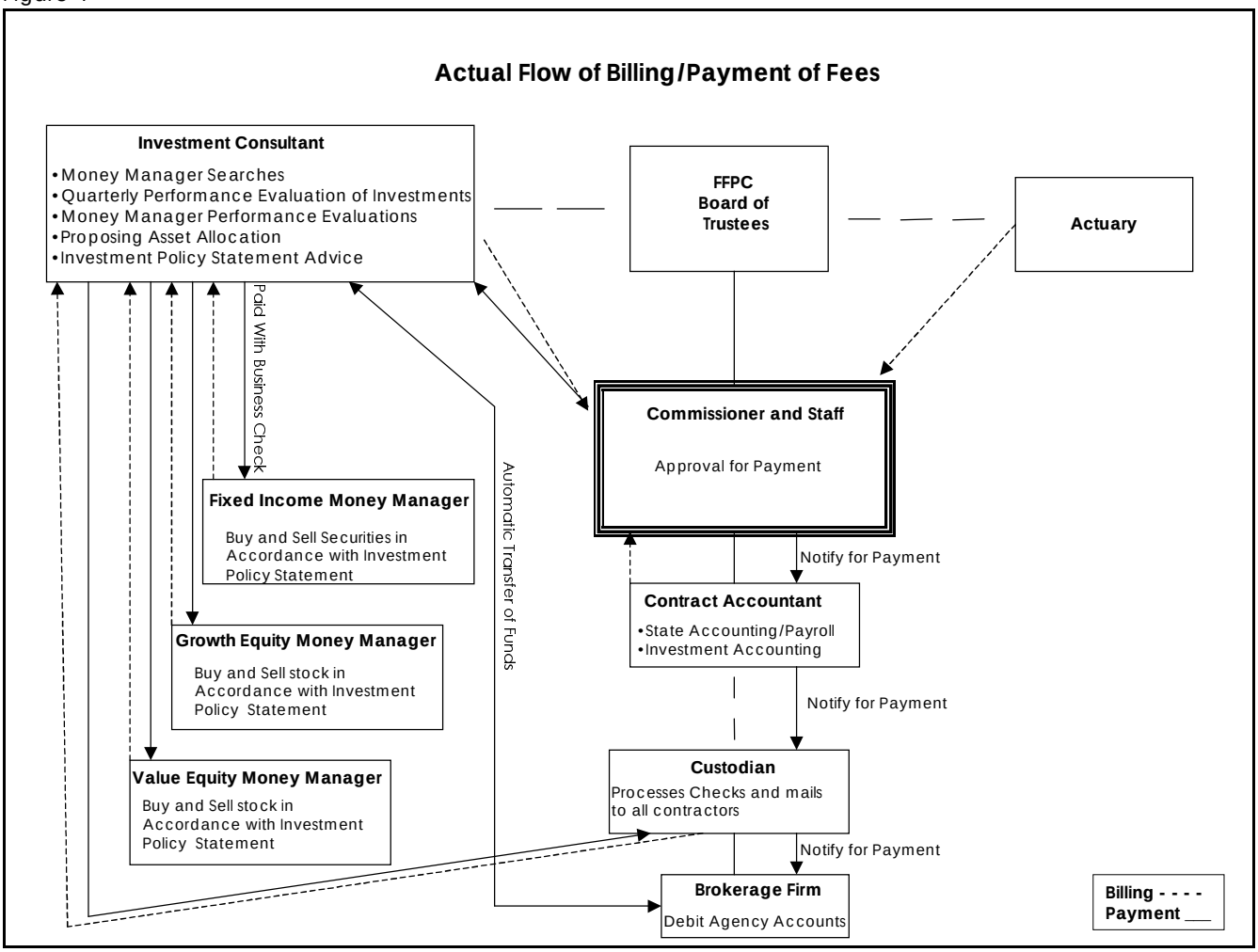
- Prior approval was not required for all payments made with Commission funds, as required by Commission policy. Although there was a procedure in place at the Commission for the payment of bills/fees, the Consultant's contract allowed him to automatically debit his quarterly fee payments after he became the Commission's official Investment Consultant.

Figure 3



- **The Commission did not properly oversee its contractors.** The Commission did not properly oversee its contractors to ensure that services provided were limited to those designated in each contract. As mentioned above, the contract provisions did not establish proper segregation of duties between the Consultant, the Money Managers, and the Custodian of funds. Better oversight of contract activities would have alerted the Commissioner that proper controls were not established and that contract amendments would be necessary. For example, the Consultant made eight transfers out of the Commission's funds (totaling $61,494.38) and seven transfers in (totaling $6,791.58) before the Contract Accountant brought the issue to the Commissioner's attention. Six of these transfers out were made per a provision in the Consultant's contract that "Quarterly fees . . . will be debited to the Client's Account on the dates they are payable." Proper control procedures would have ensured that all fees were invoiced to and approved by the Commissioner before being paid.

Figure 4



Recommendations:

The Commission should establish effective contract administration controls over investment activities, including controls over contractor selection, contract provisions, contract payment methodology, and contractor oversight. The Commission should also ensure that contracting procedures conform to good business practices and state requirements; that proper segregation of duties between consultants, money managers, and custodians of funds are established; and that additional compensating controls are established with Commission staff and its Contract Accountant. Specifically, we recommend the following:

- Limit the activities of contractors to those services designated in the contract. For example, the investment Consultant's services should be limited to giving advice on asset allocation and investment policy, identifying Money Managers, evaluating the performance of the Money Managers, and providing quarterly performance measurement summary reports.

- The Board of Trustees should require legal counsel to review contracts for professional services prior to final approval. This review should ensure that the contract is in agreement with the decisions of the Board and includes provisions that safeguard the State's and the Commission's interests. Contracts should include provisions that give auditors access to information.

- The Board of Trustees should approve any request for proposal (RFP) process prior to initiation. The Commission should ensure compliance with purchasing and historically underutilized business provisions of General Services Commission requirements and Board ethics policy. Documents related to an RFP and selection process may be subject to open record requirements and should be maintained by the Commission.

- All fees for contracted investment services should be invoiced and sent to the Commissioner. The Commissioner should review each invoice for accuracy and contract compliance by verifying market values and performing a recalculation of the fees where appropriate. Evidence of this review should be documented prior to the Commissioner's approval of the invoice for payment. Approved invoices should be paid by check drawn on the State Treasury and recorded in the State's accounting system, USAS.

- The payment provisions in the current contract with the investment Consultant should be amended. Quarterly fees should not be debited from the investment accounts. As stated above, the fees should be invoiced and sent to the Commissioner for proper review and approval. The fees should be paid by check drawn on the State Treasury.

- Terms for payment of fees for services should be detailed, fully documented, and understood by the Board, Commissioner, and Contract Accountant at the start of the contract.

- The Commission should develop a monitoring system to evaluate controls over and assess the risk inherent in Commission operations. Controls over investment operations should be monitored closely since this is the Commission's major function. Significant control weaknesses should be reported to the Board.

- The Contract Accountant should have the ability to view the Commission's accounts on-line.

Section 2:

The Board Failed to Provide Adequate Governance and Oversight for Commission Activities

Section 2-A:

Failure to Disclose Business Relationships Between Board Members and the Consultant Did Not Comply With the Board's Ethics Policy and Could Give Rise to the Appearance of a Conflict of Interest

Currently, the Board Chair and one member of the Board's Investment Committee are clients of the company established by the Consultant. These Board members did not comply with the Commission's ethics policy when they voted on awarding the Consultant's company an investment consulting contract on June 6, 1997. The Board's policy requires that Board members actively avoid both the appearance and the fact of a conflict of interest. (See Appendix 3 for the Board's Code of Ethics.)

Whenever a matter comes before the Board that may pose a conflict, a potential conflict, or the appearance of a conflict of interest, the Board members are supposed to recuse themselves from consideration of the matter. This is the case unless after full disclosure at a public Board meeting of the facts underlying the appearance of conflict, the Board determines that no conflict or potential conflict exists. The Board Chair and the other Board member had accounts with the Consultant's company as early as February 1997. These Board members did not disclose this fact at either the March 1997 or the June 1997 Board meetings.

Recommendations:

Board members should disclose any business relationships with the Commission's contractors and, in consultation with legal counsel, recuse themselves from decisions that may involve potential conflicts.

Board members should ensure compliance with the Board's ethics policy in all aspects of their duties. If necessary, additional procedures should be developed and appropriate corrective or disciplinary actions should be taken.

Section 2-B:

Board Approval of Changes to Critical Commission Functions Was Made Without Adequate Time for Deliberation and Was Based on Limited Information

The Board's approval of changes to the Commission's investment consulting and custodial firms was made without adequate time for deliberation and was based on limited information. Thus, the Board had no reasonable assurance that its actions

would help achieve the objectives of the Commission. (See Appendix 2.1 for a chronology of events.)

At a September 5, 1996, meeting, the Board:

- Received a proposal from the prior Investment Firm to continue current, official business arrangements
- Approved a change in custodial firms for a period of six months
- Approved a change in investment consultants to the Consultant's new company for a period of six months
- Terminated its contract with the prior Investment Firm

Members of the Board expressed dissatisfaction during the meeting that the Board had not been involved in the contracting process. They also expressed dissatisfaction that they were not given a chance to review the contractor's proposals for custodian services. A request to table the Board's action on these contracts to the second day of the meeting to allow Board members more time for better analysis was rejected by the Board Chair.

It appears that only the Board Chair knew about the Commissioner's plans to change investment consulting and custodial firms before this meeting. The Commissioner apparently began plans to change the Commission's investment consultant and custodian in early summer 1996, at least seven weeks before the September 5, 1996, Board meeting. However, the Commissioner had apparently not informed other members of the Board of these plans.

At the September 5 meeting, the Board received information from the Board Chair, the Commissioner, and the Consultant about the prior business arrangements of the Commission. In the following respects, information presented to the Board was incomplete or inaccurate:

- The Board was informed that the Commission's contract for investment consulting services had been with the Consultant since the contract began in 1990, and not with the Investment Firm with which he was employed However, the Commission's original contract for investment consulting services was with the Investment Firm. The Consultant was an employee of the Investment Firm.
- The Board was informed that the Commissioner always considered the investment consulting contract to be with the Consultant and not the Investment Firm. However, the Commission's original contract for investment consulting services was with the Investment Firm.
- The Board was informed that payments for investment consulting services were issued directly to the Consultant and not to the Investment Firm.

However, payments were actually made to the Investment Firm rather than to the Consultant.

In addition, the Board's access to information about the options available to the Commission was limited. The Board was not provided with the proposals that had been reviewed by the Consultant, nor did it hear any presentations from the two firms the Consultant judged to be qualified. The Consultant had advised the two firms to prepare presentations for the Board, but subsequently canceled plans for these presentations.

The Commissioner asserts that the Investment Firm that had previously provided both custodial and investment consulting services was unwilling to continue providing just custodial services. However, throughout the meeting a representative from the Investment Firm continued to indicate that the Investment Firm would contract with the Commission for custodial services alone.

Recommendations:

All Board members should be informed of all decisions, possible decisions, or possible proposals (by the Chair and Commissioner) affecting the fund well in advance of Board meetings.

The Board of Trustees should approve any RFP process prior to initiation. Board members should establish evaluation criteria and identify evaluation factors and their relative importance to the proposed work or project. The criteria should measure how well the proposal meets desired performance requirements. If the Board members vote to delegate the review of the proposals they should review tabulation documents and gain sufficient information to make informed decisions.

The Board should establish a formal process with written criteria to evaluate the performance of all contract providers. This would include the investment Consultant's performance evaluation of the Money Managers and independent performance evaluations of the investment Consultant, the Custodian, and the Actuary.

The Board should establish a policy to decide how the Commission should handle unexpected changes with providers of contract services.

The Board should document what authority it has delegated to the Commissioner.

Section 3:

Ensure Compliance With State Law Requiring the Transfer of Uninvested Cash to the State Treasury

The Commission does not return uninvested cash to the State Treasury. Instead, all cash is reinvested into money market accounts at the Custodian/Brokerage Firm. At March 31, 1997, the Fund held $948,605.73 in the form of money market funds in such accounts.

Ensuring that the Commission's funds are always invested is a prudent investment practice. However, investing idle cash directly into money market funds does not comply with state law. The Texas Statewide Volunteer Fire Fighters' Retirement Fund is a trust fund in the State Treasury and, as such, is required to maintain all cash balances at the State Treasury. Therefore, to comply with state law the Commission must return cash to the State Treasury where it earns depository interest until it is reinvested.

Transferring cash balances from the Custodian/Brokerage Firm to an account at the State Treasury would also improve control over Commission operations. Currently, fees paid to contracted investment, accounting, and actuary providers are paid for out of the cash held at the Custodian/Brokerage Firm instead of by state warrant as required by law. We identified weaknesses in the controls over fee payments at the Custodian/Brokerage Firm.

Maintaining cash balances at the State Treasury and requiring processing of fee payments through the State Treasury would ensure that established state controls over cash balances and vendor payments are in place. All fee payments would be paid with state warrants processed according to State Treasury procedures and recorded in the State's accounting system, USAS. All contractors would be required to register with the State as vendors.

Recommendations:

All uninvested cash balances should be transferred back into the State Treasury.

All payments for contracted investment services should be paid by warrant drawn on the State Treasury and recorded in the State's accounting system, USAS.

Management's Responses

EXECUTIVE SUMMARY

The Commission does not agree that external intervention is appropriate. This audit is mostly concerned with control weaknesses in the "wrap fee" arrangement which the Fund no longer participates in. This arrangement was entered into for FY 96 and the Board ended that arrangement at the end of FY 96.

The Commission should not be required to contract with ERS. However, the Commission could ask for bids from ERS along with other professional managers and the Board take into consideration various services available from different sources.

The Commission's response to specific control issues is as follows.

The Governor appoints the Commissioner and certainly takes into consideration the qualifications of all appointees.

Management (Commissioner and Accountant) has already discussed the need for an internal audit function. The issue will be brought to the Board for decision. Cost would have to be taken out of the Fund.

The Commission is willing to report to Legislature in whatever manner deemed appropriate.

The Commission will abide by appropriate General Services Commission rules.

Specific language is now included in contracts to give auditors access to information relating to the pension fund.

The issue of effective administration controls over investment activities center around an emergency situation when the Consultant the fund had since 1990 left the parent company and all of the division in the parent company went with him. They were the only contact we ever had with the parent company. Due to the unique nature of the situation, the Board choose to cease its contract with the parent company and contract with the people we had done business with for over six years. After that change on an interim basis, the Board went out with an RFP, which was published in the Texas Register, for Consultant Services. Eight firms applied, four were interviewed and one selected.

The issue of failure to provide adequate governance and oversight in the disclosure of business relationships between two board members and the Consultant was addressed at the September 1997 meeting. Full disclosure was presented to the Board. They in turn, voted that the issue was not a conflict of interest thus making the June '97 vote valid.

The issue of cash in the money market funds was addressed at the September '97 meeting. The snapshot of the $948,505 in the money market fund was due to the maturity of the GIC. This amount was available for the new investment manager hired at the June '97 meeting. The Board voted at its September '97 meeting that the money is an investment and is not received as cash. Thus it will remain at the custodian in the money market investment. Beginning immediately all fees will be paid through the Treasury and funds transferred as necessary.

The limitations of access to information from outside contractors has been eliminated with the following language which has been approved by the Attorney General's Office. It states: "The Client, or the Texas State Auditor's Office as its agent, shall have access, upon reasonable notice to (contractor), to all records at the (Consultant's Office) pertaining to consulting services (or other services pertinent to particular control) provided to client under this agreement."

Section 1

Section 1-A:

The Board's Investment Committee has been active and involved during the past fiscal year. They have restructured the portfolio and have established long range plans to complete that restructuring process. The Investment Committee, the Board, and the Commission takes a great deal of pride in its professional approach to portfolio structuring, review of risk/reward, and in the fact that the fund continues to surpass its benchmark in rate of return. The use of private sector Consultant is of great benefit to the Investment Committee and the Board.

The contractual procedures used for new custodial services and investment Consultant services were accomplished in an unusual and on an emergency basis.

When the Board was informed by the former custodian that they would no longer provide custodial services, the Board and the Commission relied on the expertise of its Consultant to assist in selecting a new custodian. This was accomplished in a timely manner and, in fact, the new custodian performs in an excemplimanry manner for the fund.

The Commission, after the "six month emergency" contract with the Consultant, went out for RFP's. The RFP was listed in the Texas Register, thus providing access to anyone who would want to bid. Eight responses were received. The Consultant Committee reviewed all bids and narrowed them down to four for full Board interviews and review.

The contract Consultant continued to perform evaluation services without interruption. The Consultant, not the firm, presented the report to the Board because he and his staff were the only ones who ever prepared those reports, whether they were at the original firm or the new company.

Once again, the Board and the Commission handled the custodian issue in an expedient manner due to the emergency nature of the situation.

Section 1-B:

The new contract with the Consultant provides specific designation of duties.

The Board voted at its June "97 meeting to require that all contracts be reviewed by the Attorney General prior to final approval.

The Board will comply with State RFP requirements.

All fees are invoiced and sent to the Commissioner for approval and review for accuracy. All fees will be paid through the State Treasury and recorded in the State USAS system.

There are no debit provisions in the current Consultant's contract. Fees are paid out of the Treasury (board action September '97).

The Board, Commissioner and Accountant are reviewing policies and controls to assure a proper monitoring system.

The issue of on-line access for the Commission is one still being discussed for its merits and justification.

Section 2

Section 2-A:

Section 2-A questions the ethical conduct of two Board members who voted in favor of retention of the Consultant in June 1997. The Auditor's accusation is unfounded because the nature of the Board members' accounts in question do not allow for discrimination in favor of the various clients of the Consultant who hold similar accounts.

The accounts maintained at the Consultant by each of the two the Board members in question are investment advisory accounts in which the Consultant recommends an allocation of funds between mutual funds selected by the Consultant. The Consultant does not serve as investment adviser to the mutual funds and does not trade securities on behalf of any such accounts. A standard fee is charged to all such accounts equal to a percentage of assets under management. Moreover, all decisions with respect to such accounts are made based on economic and market factors and then implemented across the board for all such accounts at the same time on a uniform basis. No individual account is in the position to benefit at the expense of another. All such accounts are billed according to a standardized fee schedule, and the Consultant is not in a position to give, and does not give, preferential treatment to any client -- ***all such accounts are treated exactly the same****. There is no inside knowledge of securities trading activity that could be imparted, no trading strategies that could be executed, and no fee arrangements that could be entered, on a basis more favorably for the Board members as a result of the fact that the Commission also has an account with the Consultant. In other words, there is no way for Board members to use their accounts to benefit personally, to use Commission property for personal gain, or to take any other action incompatible with their public duties.*

The Board, at its September '97 meeting, had an agenda item to discuss the issue of conflict of interest. The two board members in question revealed their investment relationship with the Consultant to the board. After discussion, the board voted that a violation of the Ethics Policy did not occur and there was no conflict of interest. Thus, the June '97 vote was a valid vote.

Each Board member files a Financial Report with the Texas Ethics Commission annually.

Section 2-B:

The Board will review all of its procedures concerning the RFP process and the handling of unexpected changes, during FY 98.

The Board has historically commended the Commissioner on keeping them informed of all issues related to the Fund.

The Board will work closely with the new Commissioner while establishing guidelines and authority delegated to the Commissioner.

Section 3

The Fund never has "idle Cash" not drawing interest. The Money Market Fund is an investment and draws interest. The Board voted at the September '97 that the Money Market would remain at the Custodian. Funds will be transferred to the Treasury as needed to pay invoices through USAS.

Controls are in place at the Custodian, which did not constitute a weakness over fee payments.

All invoices will be paid by warrant drawn on the State Treasury and recorded in USAS.

MANAGEMENT CONCLUSION

The scope of this Management Audit which has lasted for six months, has centered around one emergency issue (the Consultant leaving the Investment Firm and forming his own company) and the actions taken by the Board during that unusual time. State officials have been brought into the audit and contractors have been reported to regulatory authorities. The time spent on this audit is totally out of proportion to any serious issues addressed. Literally, for the past six months, my time has been consumed by this audit.

*The Board, the Contractors, the Commissioner, and Staff are competent, have integrity, and want only what is best for this fund. The way this whole process has been blown totally out of proportion is very unfortunate. This Fund was **never at risk,** is not at risk now, and is managed in a manner that has provided for consistent growth, rates of return exceeding the fund's benchmark, actuarial soundness,*

provision for COLA, respect of the constituents it serves, all of which is accomplished with a minimum staff and resources. I'm very proud of the work that this team of professionals has accomplished.

This Fund, in the past 10 years has grown from $7.5 million to almost $25 million. Participation has increased from 103 departments to 150. This increase has been accomplished without additional staffing or funding. The level of dedication by the Staff of the Fire Fighters' Pension Commission is second to none. It is very discouraging when a five person staff does the work of ten and then gets blasted in the manner we're experienced.

The Management is certainly receptive to putting additional controls in place where needed. It is the desire of the management, the staff, and the professional contractors, to assure that the Statewide Fire Fighters' Pension Funds is safe, which we believe without doubt, that it is.

State Auditor's Follow-Up Comments

We do not believe that it is possible to achieve a common understanding about the significance of the issues discussed in this report with the Commissioner and Board of Trustees. Although conceding many of the facts included in our findings, they disagree with the conclusions we have reached. Given this situation, we believe it is best to move forward with corrective action.

The Board and the Commissioner have provided an action plan to address all recommendations in this report by the end of 1998. (See Appendix 4.) The Chair of the Board has also requested assistance from the State Auditor's Office to ensure successful implementation of this plan.

We will monitor the Commission's progress on this corrective action plan and provide comments as necessary to help the Commission implement the plan. We will also report the results of our monitoring to the Legislature.

Our willingness to work with the Commission in its efforts to implement a corrective action plan does not, however, alter our belief that intervention from external oversight officials is necessary to establish effective control over the operations of the Commission. The prior record and current responses of the Commissioner and the Board limits our confidence that the Commission is committed to corrective action and proactive improvement of the control environment. The control environment will continue to be susceptible to material weaknesses until there is a fundamental shift in the Commission's awareness, acceptance, and understanding of internal controls.

Our primary interest is in moving forward with corrective action. However, we feel an obligation to identify some of the statements contained in management's response which are factually inaccurate. These statements are listed below. Each is followed by the actual fact(s).

- *This audit is mostly concerned with control weaknesses in the "wrap fee" arrangement which the Fund no longer participates in.*

Facts: We audited the contractual arrangements and reported on the control weaknesses that existed during fiscal year 1997 (September 1996 through May 1997). The scope of this audit was not the "wrap fee" arrangement. The Fund participated in the "wrap fee" arrangement during fiscal year 1996 (See Appendix 1, "Objective, Scope, and Methodology" for further information.)

Wrap Fee:
One fee paid to the Investment Consultant for a variety of services. Significant services offered by or through the Investment Consultant under the wrap fee arrangement are:
- Investment consulting
- Custodial services
- Discount brokerage commissions
- Direct fee payments to Money Managers out of total wrap fee

- *The issue of effective administration controls over investment activities center around an emergency situation when the Consultant the fund had since 1990 left the parent company and all the division in the parent company went with him.*

The scope of this Management Audit which has lasted for over six months, has centered around one emergency issue . . . and the actions taken by the Board during that unusual time.

Facts: The issue of effective administration controls over investment activities and the scope of this Management Control Audit goes well beyond the contracting process which concluded at the September 5, 1996, Board meeting. We audited the controls over contract provisions, contract payment methodology, and contractor oversight, as well as controls over contractor selection.

Our fieldwork began on March 10, 1997, and was completed by June 1, 1997. We also audited the Commission's fiscal year 1996 financial statements during this time. The release of this audit report has been delayed for two months to allow adequate due process for the State Auditor's Office to address the Commission's and its Consultant's concerns about the weaknesses identified in this report.

- *The snapshot of the $948,505 in the money market fund was due to the maturity of the GIC. This amount was available for the new investment manager hired at the June '97 meeting.*

  Facts: At March 31, 1997, the Fund held $948,605.73 in money market funds. The Guaranteed Investment Contract (GIC) did not mature until May 29, 1997. Therefore, the cash in the money market funds (see Section 3) was not due to the maturity of the GIC. The GIC contributed an additional $943,775.80 (projected maturity amount) of cash into the money market funds when it matured.

  State law requires that all cash receipts from the sale or maturity of an investment, interest payment, or dividend payment be brought into the State Treasury prior to being reinvested.

- *The contractual procedures used for new custodial services and investment Consultant services were accomplished in an unusual and on an emergency basis.*

  Once again, the Board and the Commission handled the custodian issue in an expedient manner due to the emergency nature of the situation.

  Facts: The Commissioner and the Chair of the Board knew on July 9, 1996, that the Consultant was planning to leave the employment of the Investment Consultant/Custodian firm and start his own company. The remaining Board members were not involved in the process to change contracted investment service providers until the next scheduled Board meeting on September 5, 1996. We believe there was sufficient time from July 9, 1996, until the Board meeting to call an emergency meeting of the Board to decide how to proceed. Early Board involvement would have eliminated the "emergency nature of the situation."

- *When the Board was informed by the former custodian that they would no longer provide custodial services, the Board and the Commission relied on the expertise of its Consultant to assist in selecting a new custodian.*

  Facts: The Commission began the selection process for the new custodian prior to the September 5, 1996, Board meeting. The Investment Firm was still under contract with the Board for both consultant and custodial services at this meeting. A representative from the Investment Firm testified at this meeting that the Investment Firm would continue to provide either both consultant and custodial services or just custodial services.

- *The Board, at its September '97 meeting, had an agenda item to discuss the issue of conflict of interest. The two board members in question revealed their investment relationship with the Consultant to the board. After discussion, the board voted that a violation of the Ethics Policy did not occur and there was no conflict of interest.*

  Facts: The two Board members should have disclosed their investment relationship with the Consultant at the June 1997 Board meeting and prior to voting on the Consultant's contract.

- *Controls are in place at the Custodian, which did not constitute a weakness over fee payments.*

  Facts: Proper controls were not in place at the Custodian at the time of our audit and during the period we audited. A representative, other than the Custodian's representative, at the brokerage firm directly debited the Commission's accounts without the Commission's and the Custodian's prior knowledge. Weaknesses in controls over fee payments existed.

- *The Fund never has "idle Cash" not drawing interest. The Money Market Fund is an investment and draws interest . . . . Funds will be transferred to the Treasury as needed to pay invoices through USAS.*

  Facts: The issue is not whether or not the money market fund is an investment. The issue is that state law requires that all cash receipts from the sale or maturity of an investment, interest payment, or dividend payment be brought into the State Treasury prior to being reinvested. The cash should then be transferred from the State Treasury to the Custodian in the amounts and at the time necessary for the Money Managers to purchase additional investment instruments. The cash cannot merely be placed in a money market fund at the Custodian.

  It will not be necessary to transfer funds from the Custodian to the State Treasury to pay invoices if all cash balances are maintained at the State Treasury. The Commission is responsible for monitoring to ensure that its accounts at the Custodian consist of investment instruments which are representative of a Money Manager's specified investment style.

Appendix 1:

Objective, Scope, and Methodology

Objective

Our audit objective was to follow up on issues identified during the small agency management control follow-up audit of the Office of the Fire Fighters' Pension Commissioner:

- Board oversight of investment activity and contracted investment services
- Compliance with investment policy statement
- Implementation of prior recommendations resulting from our analysis of investment activity

Prior to the release of our management letter in September 1996, the Commission experienced several changes in its contracted investment services. In lieu of releasing the report we discussed all recommendations with the Commissioner and made clear our intent to follow up on the recommendations as part of the fiscal year 1996 annual financial opinion audit. (See Appendix 2.2 for details.)

Once we were on site, it became apparent that we should focus our work on the issue of Commission oversight of contracted investment services.

Scope

The scope of this audit included consideration of the Board's oversight, contracting procedures, and controls over investment operations and expenditures.

Scope Limitation

The scope of our review was limited by a difficulty in obtaining access to information from outside contractors. This caused unnecessary delay in the completion of audit fieldwork and made certain audit issues more difficult to examine and resolve. We recommend that the Commission include provisions in future contracts that expressly authorize auditors to review contractor records and information relating to the management of the pension fund.

Methodology

The methodology used included collecting information, performing audit tests and procedures, and evaluating the information. The audit was done in connection with the annual financial statement opinion audit. See SAO Report No. 98-002 for the results of the opinion audit.

Information collected to accomplish our objective included the following:

Interviews with:

- The Commissioner and Commission staff
- Contracted investment providers and accountants
- Other state agencies' employees

Documents such as the following:

- Board and committee meeting agendas and minutes
- September 5, 1996, Board meeting tapes
- Approved investment policies
- Investment and operating policies and procedures
- Applicable state laws and statutory provisions
- Contracts with investment consultants and custodians and money managers
- Investment transaction documentation
- Commission files
- Documents related to contracts for investment consultant and custodial contracts
- Financial Statement Disclosures

Test and procedures conducted included the following:

- Inquiries of entity personnel
- Completion of internal control structure questionnaires
- Observation of board or committee meetings
- Review of investment and operating policies and procedures
- Observation of documents or reports to determine that appropriate procedures have been performed
- Tests of certain investment transactions for compliance with control procedures and contractual provisions
- Review of contractor selection and evaluation procedures and documents
- Review of contracts for appropriateness of terminology and prior approval by legal council
- Comparison of certain contractor billings with contractual rates
- Review of financial statement disclosures for appropriateness
- Review of state laws and agency rules

Criteria used to evaluate information received included the following:

- Board's investment policy and Board and Commission operating policies and procedures
- Contractual provisions
- State laws and agency rules
- Standard audit criteria

Other Information

Fieldwork was conducted from March 1997 through May 1997. The audit was conducted in accordance with applicable professional standards, including:

- Generally Accepted Government Auditing Standards
- Generally Accepted Auditing Standards

The audit work was performed by the following members of the State Auditor's Office staff:

- Robin Smith, CPA (Project Manager)
- Susan Riley, CPA (Quality Control)
- Carol Smith, CPA (Audit Manager)
- Craig Kinton, CPA (Audit Director)

Appendix 2:

Background Information

Appendix 2.1:

Chronology of Events Leading to Change In Organization of Commission's Investment Consultant and Custodial Contractors

On August 31, 1996, the Commission's investment activities were carried out under the following business arrangements:

Table 1

Contracted Function	Explanation	Comment
Accountant • State accounting • Investment accounting	The Commission contracted with a private sector firm to provide accounting services.	
Investment Consultant • Advise on asset allocation and investment policy • Aid in money manager selection • Quarterly performance measurement - portfolio • Money manager performance evaluation	The Commission had a contract with a national financial services firm for investment consulting and custodial services. The firm had been the Commission's investment consultant since 1990. The firm had been custodian for only one year.	Commission had decided to move to a "wrap fee" arrangement, with one firm being both consultant and custodian, on the advice of the Consultant when he was employed by the firm. We recommended controls that the Commission would need to have in this higher-risk business arrangement. Commission established some of the controls we recommended.
Custodian • Recording and reporting of all investment transactions • Maintaining investment accounts		
Money Managers • Make all buy and sell decisions based on Commission's investment policy • Interact with brokers and custodian for trade execution	The Commission had contracted with three firms to provide money management services. One firm handled buy and sell decisions for the Commission's fixed-income portfolio. The other two firms handled buy and sell decisions for the Commission's growth and value equity portfolios.	

Under this arrangement, the Commission paid $72,744 for investment consultant and custodian services (fiscal year 1996). The value of the pension fund was $19.4 million on August 31, 1996. An additional $79,807 was paid for money manager services.

During the period from August 1, 1996, to October 1996, the Commissioner and the Board made a series of decisions which changed this business arrangement. The chronology of changes and the impact these decisions had on increasing the risk to the Commission's funds were as follows:

Table 2

Date	Decision/Change	Effect on Risk to the Commission's Funds
Early Summer 1996	• Employee assigned to the Commission's account by its investment consultant firm informs the Commissioner of plans to become self-employed. • The Commissioner agrees to work in confidence with employee.	• The employee of the investment consulting firm becomes the Consultant working in the private sector. • There is no longer any contractual relationship between the Commission and the Consultant. Without a contract defining the Consultant's responsibilities, the Commission has no mechanism to ensure that the duties performed by the Consultant were in the best interest of the Commission or in compliance with state requirements and Commission policies.
July 19, 1996	The Commissioner begins to receive information on services provided by another custodial firm. The Commissioner was introduced to the new firm by the Consultant.	The Commissioner is unaware of the fact that this custodial firm does not actually hold its client's investments. Instead, the investments are held by a brokerage firm that also has established business relationships with the Consultant.
August 1, 1996	Consultant leaves employment of the firm which provided investment consulting and custodial services to the Commission.	Although there is now no formal contractual relationship in place between the Consultant and the Commission, he is allowed to advise on and participate in operational decisions.
August 6, 1996	The Commissioner orders the Investment Firm not to assign a new employee to manage the Commission's accounts.	Commission's accounts had no officially designated supervision for a period of 36 days, although its contract with the Investment Firm was still in place.

Table 2 (continued)

Date	Decision/Change	Effect on Risk to the Commission's Funds
August 7, 1996	The Commissioner informs the employee selected by the Investment Firm to take over the Commission's accounts that he cannot be authorized to perform work for the Commission until approved by the Board at the September meeting.	• All members of the Board were not notified of the Commissioner's plans to change the investment consulting/custodian contracts. • The Commission was unable to receive reports critical to monitoring the activities the Investment Firm performed on its behalf.
August 7, 1996	• The Commissioner begins process of soliciting proposals for a new custodian. • The Commissioner's RFP instructs all proposals to be sent to the Consultant. • The Commissioner did not solicit a proposal from the Investment Firm which was current Custodian and Investment Consultant. (The General Services Commission [GSC] has delegated purchasing functions to agency employees who are required to adhere to ethical standards and avoid all conflict of interest in purchasing activities.)	• The Commissioner has designated a Consultant to perform official duties of the Commission although the Consultant has no official contractual relationship with the Commission. • Most Board Trustees had no knowledge of this RFP being conducted. It appears only the Board Chair had knowledge. • RFP process violated requirements for state contracting procedures for competitive bidding. The purchase of custodian services is not exempt from GSC purchasing rules. **There is a risk that GSC could revoke the Commission's authority to perform purchasing functions for not following required procedures.**

Table 2 (continued)

Date	Decision/Change	Effect on Risk to the Commission's Funds
August 29, 1996	The Consultant: • Reviewed the proposals, determined eight firms did not respond, rejected three of five proposals received, and urged two respondents to make a presentation at the September Board meeting. • Sent letters to this effect prior to contacting the Commissioner for approval. • Informed the Commissioner of custodian proposal responses, which were rejected, and two remaining viable candidates.	• We found no documentation to indicate that the Commission's staff or Board ever reviewed the proposals for a critical function of the Commission. • Although he still had no official contractual relationship with the Commission, the Consultant began to determine what information would be presented to the Board. • Documents related to an RFP, proposals, and the selection of proposals may be subject to open records and should be maintained by the Commission. The Commission did not have the proposals or documents related to the selection of the proposals on file.
September 4, 1996	The Consultant provides the Commissioner with an Investment Management Services Agreement for review and comment.	Cover letter stated, "we have revised our ***continuing*** consulting contract agreement to properly reflect the upcoming choice of changing custodianship from" the Commission's Investment Firm "to an alternative provider."
September 4, 1996	• Consultant recommends a new Custodian to the Commissioner. (The Commissioner had discussions with the recommended Custodian in July, as a result of an introduction by the Consultant.) • Consultant cancels Board presentations of top two custodial services proposers.	• The process did not ensure that all parties considered for custodian services had the same access to information. • Although he still had no official relationship with the Commission, the Consultant again determined what information would be presented to the Board. • GSC guidelines also call for avoiding all conflicts of interest in purchasing activities.

Table 2 (continued)

Date	Decision/Change	Effect on Risk to the Commission's Funds
September 5, 1996	At a meeting of the Board, the Board: • Received a proposal from the Investment Firm to continue current, official business arrangements. • Approved a change in custodial firms for a period of six months. • Approved a change in investment consultants to the Consultant's new company for a period of six months. • Terminated its contract with the Investment Firm. The Consultant announced that prior to the meeting he had negotiated with the one money manager firm (which did not have a stand-alone contract) and could commit for them that they would accept a stand-alone contract with the Commission. (To facilitate the change in firms, the Consultant agreed to absorb the $8,000 cost of the new custodian.)	• The Board made decisions about critical business arrangements without adequate time for deliberation and with limited information. - Certain board members expressed dissatisfaction with not being informed about the RFP process and not having a chance to review the proposals. - The Commissioner and Chair misrepresented the prior, official business arrangements in place to carry out the Commission's functions. • Board disregards recommendations of its official, paid Investment Firm. • The Consultant carried out Commission negotiations without a contract defining the Consultant's responsibilities and without express authorization from the Commission.
September 6 and 13, 1996	Commissioner and Board Chair sign the contract with the new Investment Consultant (the Consultant's company).	Contracts did not receive legal review. As a result, there is a risk that the Commission's and State's interests are not protected.

Table 2 (concluded)

Date	Decision/Change	Effect on Risk to the Commission's Funds
September 10, 1996	The Commissioner allowed the Consultant (and now the official Investment Consultant) to make arrangements with the new Custodian on how the Commission's accounts would be handled.	• The Commissioner and the Board were unaware of the brokerage firm that had physical possession of the funds. • The Consultant had business relationships with and maintained business accounts at the brokerage firm, allowing him to directly transfer Commission funds despite a contract between the Custodian and the Commission that required written authorization by the Trustees or the Commissioner for transfer of funds.
October 7, 1996	Commissioner and Board Chair sign the contract with the new Custodian.	Contracts did not receive legal review. As a result, there is a risk that Commission's and State's interests are not protected.

As a result of these decisions/changes, the Commission's investment activities are now carried out under the following business arrangements:

Table 3

Contracted Function	Explanation	Comments
Accountant • State accounting • Investment accounting	The Commission contracts with same private sector firm to provide accounting services.	
Investment Consultant • Advise on asset allocation and investment policy • Aid in money manager selection • Quarterly performance measurement - portfolio • Money manager performance evaluation	Commission contracts with the company established by the Consultant. The company is absorbing the cost of the Custodian.	The company's contract granted authority which was inconsistent with established Commission controls.

Table 3 (concluded)

Contracted Function	Explanation	Comments
Custodian • Recording and reporting of all investment transactions • Maintaining investment accounts	The Custodian is a trust company but does not have physical possession of fund assets. The assets are in the possession of the brokerage firm.	• The Custodian had no prior knowledge of certain transactions processed through the brokerage firm by the Consultant. • In our initial discussions with the brokerage firm the fund was confused with the Consultant's other accounts.
Money Managers • Make all buy and sell decisions based on Commission's investment policy • Interact with brokers and Custodian for trade execution	The Commission contracts with the same three firms to provide Money Management services. One firm handles buy and sell decisions for the Commission's fixed income portfolio. The other two firms handles buy and sell decisions for the Commission's growth and value equity portfolios.	Perform duties based on instructions from the Consultant instead of the Commission.

Under this arrangement, the Commission will pay an estimated $99,660 for Investment and Custodian services (fiscal year 1997). This represents an estimated 36.92 percent increase over the previous year. The market value of the pension fund is estimated to be $21.3 million, an increase of only 9.79 percent. An additional estimated $91,970 (an estimated 15.24 percent increase) will be paid for money manager services.

Appendix 2.2:

Recommendations Made to the Commission as a Result of Our Investment Analysis Work Completed in April 1996 and Their Status

As a result of the fiscal year 1995 Opinion Audit of the Fire Fighters' Pension Commissioner, the State Auditor's Office expanded the scope of the scheduled Small Agency Management Control Audit Follow-Up to determine the reasons for the increased number of investment transactions in fiscal year 1995.

Our overall conclusion was that changes in the Commission's investment environment resulted in the increased number of investment transactions and exposed the investment portfolio to greater risk in the future. Greater risk resulted from:

- An increase in the number of equity transactions and the size of the equity portfolio
- More emphasis on growth equity holdings
- Weak internal controls because of lack of separation of the investment consultant and custodian duties
- Noncompliance with its investment policy statement

To compensate for added risk, we recommended that the Commission monitor its investments more closely and periodically verify the performance of its investments.

Prior to the release of our management letter in September 1996, the Commission experienced several changes in its contracted investment services. In lieu of releasing the report, we discussed all recommendations with the Commissioner and made clear our intent to follow up on the recommendations as part of the fiscal year 1996 annual financial opinion audit.

The following are: (1) the recommendations we made to the Commissioner as a result of our investment analysis work, (2) the conditions at the time our analysis was performed, and (3) the status of the recommendations.

Table 4

Recommendation	Condition	Status as of April 22, 1997
Obtain the billing detail necessary to accurately account for all contracted services under the "wrap" fee arrangement.	The Commission did not know how the total "wrap" fee was allocated to each provider of professional services. This information is necessary for compliance with the Comptroller of Public Accounts financial reporting requirements.	At the Commissioner's request, the State Auditor's Office wrote the Investment Firm and obtained the fee details. The Commission was unable to obtain the details through the consultant assigned to the Commission's account. The "wrap" fee arrangement is no longer in place. It was substituted with a partial "wrap" fee—only investment consulting and custodial services.
Perform ratio and trend analysis on investment data. Good benchmarks such as the accounting rate of return on investments, time-weighted rate of return on investments, and turnover ratios could be used. Investment data for analysis available to the Commission in its accounting records.	The Commission performed no ratio or trend analysis. All monitoring responsibilities were delegated to the Investment Consultant.	The Commissioner states that the ratio and trend analysis provided by the Investment Consultant is "validation enough."
Perform verification of market values in the custodian reports every quarter. Publications such as the *Wall Street Journal* and *Moody's Bond Record* can be used to verify market values of individual investments.	The Commission did not verify the accuracy of market values reported.	The Commission's Contract Accountant has been instructed to verify market values on a sample basis each quarter.
Validate and confirm from primary sources the accuracy of the performance data contained in the Consultant's reports by performing ratio analysis and using data from Money Managers' reports.	The Consultant's reports contain the following disclaimer: (we) "will not be liable to anyone who fails to validate or confirm from primary sources the accuracy of the information contained herein."	The Commissioner states that the ratio and trend analysis provided by the Investment Consultant is "validation enough."

Table 4 (concluded)

Recommendation	Condition	Status as of April 22, 1997
Establish a formal evaluation process with written criteria to evaluate the performance of the Commission's Investment Consultant and Custodian.	The Commission had no formal evaluation process for the Consultant and Custodian.	The Commissioner states that "when the Board does due diligence on the selection of its contract providers, there has to come a time when there is a level of trust, along with the proper reviews to determine that they are performing in a satisfactory manner. If we begin to hire consultants, managers and actuaries to submit to another level of review, it seems to be a never ending process."
Provide additional investment training for Board members from sources other than the Commission's Investment Consultant and Money Managers. Training from other sources can provide increased objectivity in the Board's decision-making process.	The majority of the Board's investment training was conducted by the Investment Consultant and Money Managers who also advise the Board and report portfolio performance results. Board members contacted during our analysis expressed a desire for additional training from outside sources.	The Commissioner states that "it is somewhat redundant to have outside managers come in to 'educate' our board."
Monitor its asset allocation between the different types of investments to ensure that it is in compliance with the Board's established investment policy. In addition, the Board should specify an acceptable range of allocation between value equity, growth equity, and fixed-income investments.	On September 30, 1995, the Commission was not in compliance with its Board's policy on asset allocation. The Commission's allocation for value equity was 38.72 percent, exceeding the Board's policy of 25 percent. The Commission's allocation for fixed-income securities was 38.14 percent, below the Board's policy of 50 percent.	The Board of Trustee's Investment Committee is in the process of formalizing its monitoring procedures. In the March 1997 Board meeting, the Board adopted acceptable ranges of asset allocations and a new asset allocation policy.
Ensure that the Investment Firm reports the $500,000 Government Insurance Contract (GIC) on the Custodian's statement.	While performing investment reconciliations, the Commission's Contract Accountant found that the Custodian was not reporting the $500,000 GIC.	The Commissioner informed the Custodian to report the GIC. The Custodian never reported the $500,000 GIC.

Appendix 2.3:

Additional History of Material or Significant Control Weaknesses at the Commission

We limited the identification of problems to those related to investments.

August 1991, *Management Letter - Fire Fighters' Pension Commissioner*, SAO Report No. 91-150

> **A material weakness exists in the Commissioner's overall control environment.** The control environment weakness is a result of the combination of the following conditions: reconciliations were not reviewed by supervisory personnel and investment transactions were not reconciled to State Treasury records.

June 1992, *Fiscal Year 1991 Management Letter - Fire Fighters' Pension Commissioner*, SAO Report No. 92-132

> **A material weakness exists in the overall control environment**. The following conditions were noted which, taken in aggregate, indicate the existence of a material control weakness:
>
> - Investment transactions were not reconciled to external sources.
> - A double-entry general ledger accounting system was not used.
> - Supporting documentation for adjustments to receivables and investment income was inadequate.
> - GASB Statement No. 3, *Note Disclosure for Deposits with Financial Institutions, Investments, and Reverse Repurchase Agreements*, was not complied with.
> - Investment records were not maintained. Investment transactions were not recorded in the general ledger. No dividend income and interest anticipation schedule had been prepared. No summary list of investments was maintained.
> - Investments are not presented in the annual financial report in accordance with generally accepted accounting principles (GAAP). Dividends receivable was not accrued. Premiums and discounts on the purchase of securities were not amortized. Short-term investments were not properly identified. Investments were reported at market value rather than at cost on the balance sheet.

February 1993, *Fiscal Year 1992 Statewide - Office of the Fire Fighters' Pension Commissioner*, SAO Report No. 93-069

> **For the third consecutive year, the Commission has not acted in a timely manner to correct significant weaknesses.** It appears that neither agency management nor the Board has had a clear understanding of the importance of strengthening the control environment in a timely manner.

Weaknesses identified are:

- The Board has not adequately monitored an investment that presents a conflict of interest. A consultant hired to give impartial advice on where to invest funds is holding one of the Commission's investments.
- As in prior years, the Commission did not reconcile investment transactions. The Commission has since contracted with an external accountant to perform timely reconciliations for the 1993 fiscal year.

September 1993, SAO Letter to the Commissioner

In a letter from the State Auditor's Office to the Commission, we advised the Commission that while there is no direct conflict of interest in a "wrapped" fee contract, such a relationship may reduce internal controls over investment transactions. **We further advised the Commission of recommended internal controls over investment transactions that should be in place to mitigate the appearance of conflict of interest.**

March 1994, *Office of Fire Fighters' Pension Commissioner - Financial and Compliance Audit, Fiscal Year 1993*, SAO Report No. 94-052

The Commission and its Board have corrected the prior year material weakness in the overall control environment. They have implemented a general ledger accounting system and investment reconciliations.

April 1995, *An Opinion Audit on the Fire Fighters' Pension Commissioner*, SAO Report No. 95-113

- **Reconciling items in the reconciliations of the Commission's investment portfolio were not properly identified and investigated,** reconciling items noted as a timing-difference could not be traced to subsequent custodian statements, and the amount noted as "bond amortization" differs from the amortization reported in the investment records by $234,679.
- **There is no income anticipation system to accurately forecast the amount of dividend revenues due for all equity securities.**
- The straight-line instead of the effective interest method of amortization for discounts and premiums was used.
- **Improper accounting and reporting of certain professional services occurred during fiscal year 1994.**
- **Reconciling of cash in the State Treasury was not prepared properly and proper documentation was not maintained.**

April 1996, *An Opinion Audit on the Office of the Fire Fighters' Pension Commissioner*, SAO Report No. 96-062

The Commission has not implemented the following recommended internal control over investments to mitigate the appearance of conflict of interest over its contracted investment services under the "wrapped" fee contract.

- Two of the Commission's three investment managers do not report investment activity directly to the Commission.
- The Commission is not receiving the data necessary to perform complete reconciliations of the investment managers' and custodian's activities.
- The Commission does not have on-line access to verify transactions daily.

The Commission does not receive adequate billing detail to accurately account for contracted investment services. The quarterly billing under the "wrapped" fee contract does not itemize each service and allocate the fee to each service provider. The Commission cannot accurately account for its contracted investment services.

- In fiscal year 1995, the investment consultant's billing detail was not adequate to accurately account for investment consultant and brokerage fees. We found that $41,676 in brokerage fees paid to the investment consultant as consultant fees were recognized as part of the cost of investment transactions rather than as professional service fees.

June 1996, SAO Investment Review

Due to planned follow-up, no report was issued (see Appendix 2.2 for details)

- **A lack of separation of investment consultant and custodian functions results in weak controls.** One firm was contracted with to perform both consultant and custodian services. The firm also provides investment training to the Board.
- **No analysis is performed by the Commission to verify the accuracy of the information contained in the quarterly investment performance reports submitted by the consultant.** In addition, no formal evaluation process and criteria exist to evaluate the firm's performance.
- **The Commission was not in compliance with its asset allocation policy.** The allocation for value equity was 38.72 percent, exceeding the policy of 25 percent. The allocation for fixed income securities was 38.14 percent, below the policy of 50 percent.

Appendix 3:

The Office of the Fire Fighters' Pension Commissioner Board of Trustees Code of Ethics

Adopted May 1991

The State of Texas and Trustees elected or appointed to serve as governing board members of its Public Pension Funds desire to enhance and promote the professional management of their Funds, in order to provide retirement and other benefits to participants and beneficiaries who have served the State and its citizens.

To further these objectives, all Trustees shall adhere to legal, moral and professional codes of conduct in the fulfillment of their fiduciary responsibilities, and to the following standards.

Responsibilities as Trustees

Trustees shall recognize their responsibilities for the stewardship of funds entrusted to their administration and discharge their duties solely in the interest of their Fund, its beneficiaries and participants.

- They shall carry out their duties with an understanding of the obligation of public trust that they owe to the citizens and taxpayers of the State.
- They shall exercise prudence and integrity in the management and investment of pension plan assets in their custody, seeking reasoned diversification of the Fund's assets, consistent with those legal limitations which may apply.
- They shall strive to retain qualified individuals to provide professional assistance in achieving Fund objectives, informing said individuals of the fiduciary duties assumed by virtue of their employment by the Fund.
- They shall assure that the progress achieved by administrative staff, money managers, and other Fund fiduciaries be subject to periodic performance evaluation and that reasonable and necessary administrative expenses are paid.
- They shall uphold both the letter and the spirit of the legislation and regulations governing their actions. (Article 6243.e3 V.A.C.S.)

Professional Requirements

Trustees shall act with honor and integrity in the administration of their Funds.

- They shall be responsible for developing and maintaining their skills and competence as Trustees through continuing education and participation in professional associations.
- They shall not knowingly sign, subscribe to, or permit the issuance of any statement or report which contains any misstatement or which omits any material fact.

- They shall respect and protect privileged information to which they have access by virtue of their role as Trustee.

- They shall assure the Fund financial information is made available pursuant to applicable law and generally accepted practices, within the framework of state and local policies.

- They shall be responsive to inquiries by assuring that their Funds have established procedures for dealing with information requests from beneficiaries or participants, members of the public, governmental agencies and the press.

- They shall not knowingly be a party to or condone any illegal, improper, or unethical activity.

- They shall manage all matters within the scope of their authority so that fairness and impartiality govern their decisions.

- They shall respect the rights, responsibilities and integrity of their colleagues and others with whom they work.

- They shall maintain the fiscal integrity of their Funds by monitoring the timely flow of monies due to the Fund.

- They shall establish a legislative review process to monitor pending legislation, assess the actuarial impact of material proposals and, if necessary, oppose legislation if in their opinion the effect of such legislation would be detrimental to the fiscal integrity of the Fund.

- They shall promote equal employment opportunities. This standard shall expressly apply to the search for qualified minority professionals to assist Trustees in the management and handling of Fund assets.

Conflict of Interest

Trustees shall actively avoid both the appearance and the fact of a conflict of interest.

- They shall discharge their duties without favor and shall refrain from engaging in any outside matters of financial or personal interest incompatible with the impartial and objective performance of their duties.

- They shall not, directly or indirectly, seek or accept personal gain as the result of any action taken by or on behalf of the Fund.

- They shall not use public property or resources for personal or political gain.

- They shall excuse themselves whenever a matter comes before them as to which a conflict, a potential conflict or the appearance of a conflict of interest may exist, unless after full disclosure at a public Board meeting of the facts underlying the appearance of conflict, the Board shall determine that no conflict or potential conflict exists.

Appendix 4:

The Office of the Fire Fighters' Pension Commissioner Action Plan

State Auditor's Recommendation	Fire Fighter's Pension Commission Response/Action Plan	Time Frame	Responsible Entity
Section 1: Oversight and Control of Commission Investment Activities			
"Limit the activities of contractors to those services designated in the contract. For example, the investment Consultant's services should be limited to giving advice on asset allocation and investment policy, identifying Money Managers, evaluating the performance of the Money Managers, and providing quarterly performance measurement summary reports."	*New consultant contract is designed to adequately describe the scope of performance and services required.*	*Fall 97*	*Board and Commissioner*
"The Board of Trustees should require legal counsel to review contracts for professional services prior to final approval. This review should ensure that the contract is in agreement with the decisions of the Board and includes provisions that safeguard the State's and the Commission's interests. Contracts should include provisions that give auditors access to information."	*The Commissioner is responsible for obtaining advice from the Attorney General's office regarding contracts for substantial services and material changes in contracts.*	*As required.*	*Commissioner*
"All fees for contracted investment services should be invoiced and sent to the Commissioner. The Commissioner should review each invoice for accuracy and contract compliance by verifying market values and performing a recalculation of the fees where appropriate. Evidence of this review should be documented prior to the Commissioner's approval of the invoice for payment. Approved invoices should be paid by check drawn on the State Treasury and recorded in the State's accounting system, USAS."	*This recommendation regarding invoicing and payment has been implemented. Approved invoices are paid by check drawn on the State Treasury and recorded in USAS.*	*Adopted September 1997*	*Commissioner/ Contract Accountant*

State Auditor's Recommendation	Fire Fighter's Pension Commission Response/Action Plan	Time Frame	Responsible Entity
"The payment provisions in the current contract with the investment consultant should be amended. Quarterly fees should not be debited from the investment accounts. As stated above, the fees should be invoiced and sent to the Commissioner for proper review and approval. The fees should be paid by check drawn on the State Treasury."	*The Consultant's contract was amended to eliminate the ability to debit the investment accounts. Invoices are currently sent to the Commissioner for payment. Fees are paid through Treasury.*	*February 1997; July 1997; September 1997*	*Commissioner/ Accountant*
"Terms for payment of fees for services should be detailed, fully documented and understood by the Board, Commissioner and Contract Accountant at the start of the contract."	*The Commissioner and Contract Accountant are responsible for daily administration of Commission contracts; the Board is responsible for decisions on terms of major contracts.*	*Currently*	*Commissioner and Board*
"The Commission should develop a monitoring system to evaluate controls over and assess the risk inherent in Commission operations. Controls over investment operations should be monitored closely since this is the Commission's major function. Serious deficiencies should be reported to the Board."	*The Commissioner will make a report to the Board on whether future controls are necessary.*	*1998*	*Commissioner and Board*
"The accountant should have the ability to view on-line the accounts at the custodian."	*The issue of having the ability to view on-line the accounts at the Custodian has been researched and will be discussed again.*	*Winter 1997 (FY 98)*	*Board*
2.A: Ethics Policy and Appearance of Conflict of Interest.			
"Board members should disclose any business relationships with the Commission's contractors and, in consultation with legal counsel, recuse themselves from decisions that may involve potential conflicts."	*Board members disclosed their business relationship with a contractor at the September 1997 meeting.*	*September 1997*	*Board*
"Board members should ensure compliance with the Board's ethics policy in all aspects of their duties. If necessary additional procedures should be developed and appropriate corrective or disciplinary actions should be taken."	*The Board members have been reminded of the ethics policy and will discuss the policy at a future meeting.*	*FY 98*	*Board*

State Auditor's Recommendation	Fire Fighter's Pension Commission Response/Action Plan	Time Frame	Responsible Entity
Section 2.B:			
"All Trustees should be informed of all decisions, possible decisions, or possible proposals (the Chair and Commissioner) affecting the fund well in advance of Board meetings."	*The Commissioner is currently responsible for reporting agency activities to the Board. The Commissioner and Board will review whether more detailed reports are needed on items such as "possible proposals."*	*FY 98*	*Commissioner and Board*
"The Board of Trustees should approve any RFP process prior to initiation. Trustees should establish evaluation criteria and identify evaluation factors and their relative importance to the proposed work or project. The criteria should measure how well the proposal meets desired performance requirements. If the Trustees vote to delegate the review of the proposals they should review all tabulation documents and gain sufficient information to make informed decisions."	*The Commissioner and Board will work to establish a proper evaluation criteria for proposals.*	*FY 98*	*Commissioner and Board*
"The Board should establish a formal process with written criteria to evaluate the performance of all contract providers. This would include the investment consultant's performance evaluation of the money managers and independent performance evaluations of the investment consultant, the custodian, and the actuary."	*The Commissioner will make a recommendation to the Board on whether to implement more formal review criteria.*	*1998*	*Commissioner and Board*
"The Board should establish a policy to decide how the Commission should handle unexpected changes with providers of contract services"	*The commission will establish written policy on how to handle unexpected changes with providers of contract services.*	*FY 98*	*Commissioner and Board*
"The board should document what authority it has delegated to the Commissioner."	*The Commissioner and Board will review lines of authority to determine whether clarification is needed.*	*FY 98*	*Commissioner and Board*
Section 3: Ensure Compliance with State Law Requiring Maintaining of Cash Balance in the State Treasury„			
"All uninvested cash balances should be transferred back into the State Treasury."	*The Board voted to maintain Money Market accounts at the Custodian.*	*September 1997*	*Board*

State Auditor's Recommendation	Fire Fighter's Pension Commission Response/Action Plan	Time Frame	Responsible Entity
"All payments for contracted investment services should be paid by warrant drawn on the State Treasury and recorded in the State's accounting system, USAS."	*All payments are paid by warrant drawn on Treasury and recorded on USAS.*	*Fall 1997*	*Commissioner*

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