An Audit Report on

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

May 2014
Report No. 14-033
Overall Conclusion

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

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

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

Summary of Management’s Response

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

Summary of Information Technology Review

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

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

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

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

Chapter 1
TRS Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The TRS Incentive Compensation Plan

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

Source: Pure View Report, State Street Global Services.

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

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

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

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

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

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1 As of January 31, 2014, TRS had paid employees $2,744,749 of the $5,489,499 it awarded; $2,744,750 was due to be paid in 2015.
Table 1 shows the positions eligible to earn incentive compensation in the TRS plan and the incentive compensation award range for each position for the 2013 plan year.

<table>
<thead>
<tr>
<th>Eligible Position</th>
<th>Incentive Compensation Award Range (rounded to the nearest dollar)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chief Investment Officer</td>
<td>$264,240</td>
</tr>
<tr>
<td>Deputy Director Investment Officer</td>
<td>$161,847</td>
</tr>
<tr>
<td>Investment Fund Director</td>
<td>$188,620</td>
</tr>
<tr>
<td>Portfolio Manager V</td>
<td>$31,819 to $165,682</td>
</tr>
<tr>
<td>Chief Trader II</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Portfolio Manager IV - Director</td>
<td>$20,698 to $116,489</td>
</tr>
<tr>
<td>Chief Trader I</td>
<td>$88,290</td>
</tr>
<tr>
<td>Director V</td>
<td>$99,625</td>
</tr>
<tr>
<td>Portfolio Manager IV - Manager</td>
<td>$96,923</td>
</tr>
<tr>
<td>Portfolio Manager III</td>
<td>$12,474 to $91,994</td>
</tr>
<tr>
<td>Trader II</td>
<td>$36,790 to $46,484</td>
</tr>
<tr>
<td>Portfolio Manager II</td>
<td>$44,960 to $53,170</td>
</tr>
<tr>
<td>Portfolio Manager I</td>
<td>$52,627 to $66,476</td>
</tr>
<tr>
<td>Trader I (more than 4 years of experience)</td>
<td>$26,439 to $29,089</td>
</tr>
<tr>
<td>Investment Analyst IV</td>
<td>$21,521 to $57,379</td>
</tr>
<tr>
<td>Investment Analyst III</td>
<td>$16,880 to $36,444</td>
</tr>
<tr>
<td>Financial Analyst IV (Team Leader)</td>
<td>$26,588 to $34,993</td>
</tr>
<tr>
<td>Trader I (1-3 years of experience)</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Director IV</td>
<td>$41,437</td>
</tr>
<tr>
<td>Director III</td>
<td>$38,444</td>
</tr>
<tr>
<td>Director II</td>
<td>$32,280</td>
</tr>
<tr>
<td>Director I</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Investment Analyst II</td>
<td>$3,158 to $21,527</td>
</tr>
<tr>
<td>Accountant VII</td>
<td>$16,004 to $21,213</td>
</tr>
<tr>
<td>Systems Analyst VI</td>
<td>$19,301 to $27,522</td>
</tr>
<tr>
<td>Program Specialist VII</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Accountant VI</td>
<td>$12,229</td>
</tr>
<tr>
<td>Investment Analyst I (more than 4 years of experience)</td>
<td>$7,630 to $9,091</td>
</tr>
<tr>
<td>Financial Analyst III</td>
<td>$8,610</td>
</tr>
<tr>
<td>Eligible Position</td>
<td>Incentive Compensation Award Range (rounded to the nearest dollar) a</td>
</tr>
<tr>
<td>-------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Program Specialist VI</td>
<td>$12,244 to $14,241</td>
</tr>
<tr>
<td>Systems Analyst V</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Investment Analyst I (1-3 years of experience)</td>
<td>$6,909</td>
</tr>
<tr>
<td>Accountant V</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Accountant IV</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Accountant III</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Accountant II</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Executive Assistant III</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Financial Analyst II</td>
<td>$3,800 to $8,860</td>
</tr>
<tr>
<td>Financial Analyst I</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Training Specialist IV</td>
<td>$5,890</td>
</tr>
<tr>
<td>Systems Analyst IV</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Systems Analyst III</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Program Specialist V</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Program Specialist IV</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Program Specialist III</td>
<td>$6,078 to $7,262</td>
</tr>
<tr>
<td>Admin Assistant V</td>
<td>$1,083</td>
</tr>
<tr>
<td>Admin Assistant IV</td>
<td>$1,103</td>
</tr>
<tr>
<td>Admin Assistant III</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Admin Assistant II</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Executive Assistant I</td>
<td>$1,095 to $1,379</td>
</tr>
<tr>
<td>Executive Assistant II</td>
<td>$1,201 to $1,249</td>
</tr>
<tr>
<td>Program Specialist II</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Program Specialist I</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

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

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As of January 31, 2014, the PSF had paid employees $419,419 of the $838,838 it awarded; $209,710 was due to be paid in late 2014 and $209,709 was due to be paid in late 2015.
education approved the 2014 PSF incentive compensation plan prior to the start of that plan performance period.

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

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

<table>
<thead>
<tr>
<th>Eligible Position</th>
<th>Incentive Compensation Award Range (rounded to the nearest dollar and paid over three years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systems Analyst VI</td>
<td>$0 to $4,201</td>
</tr>
<tr>
<td>Systems Analyst IV</td>
<td>$2,479</td>
</tr>
<tr>
<td>Program Specialist VII</td>
<td>$0</td>
</tr>
<tr>
<td>Program Specialist V</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Staff Services Officer IV</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Staff Services Officer II</td>
<td>$1,009</td>
</tr>
<tr>
<td>Executive Assistant</td>
<td>$1,146</td>
</tr>
</tbody>
</table>

a A single amount is presented when only one individual was in the position for plan year 2013; a range of amounts is presented when multiple individuals were in the position for plan year 2013.
b During plan year 2013, the Permanent School Fund’s total fund return did not meet its benchmark. As a result, individuals employed fewer than three years and whose incentive compensation payments were based on the total fund return did not receive an incentive compensation payment.

Source: The PSF.

Recommendations

The PSF should:

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

Management’s Response from the Texas Education Agency

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

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

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

For future plan measurement periods, TEA management has ensured and will continue to ensure that the effective incentive compensation plan is formally approved by the commissioner of education prior to the beginning of any plan year.
Chapter 3

GLO Awarded Incentive Compensation in Accordance With Its Policies and Procedures

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

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

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

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

3 As of January 31, 2014, the GLO had paid employees $129,874 of the $259,747 it awarded; $129,873 was due to be paid late in 2014.
Table 3 shows the positions eligible to earn incentive compensation in the GLO plan and the incentive compensation awarded for each position for the 2013 plan year.

<table>
<thead>
<tr>
<th>Eligible Position</th>
<th>Incentive Compensation Award (rounded to the nearest dollar)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deputy Commissioner of Funds Management</td>
<td>$200,186</td>
</tr>
<tr>
<td>Real Assets Portfolio Manager</td>
<td>$49,517</td>
</tr>
<tr>
<td>Senior Financial Analyst</td>
<td>No employee in this position was eligible for incentive compensation in plan year 2013</td>
</tr>
<tr>
<td>Program Specialist</td>
<td>$10,044</td>
</tr>
</tbody>
</table>

Source: GLO.

**Recommendations**

GLO should:

- Ensure that the school land board or the land commissioner formally approves the incentive compensation plan prior to the beginning of the plan year.

- Retain documentation related to the qualitative portion of its incentive compensation plan calculations.

**Management’s Response**

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

*The GLO will retain written documentation for the qualitative portion of the incentive compensation plan as it does for standard employee evaluations.*
ERS Did Not Always Award Incentive Compensation in Accordance With Its Policies and Procedures

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

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

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

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

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

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

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4 As of January 31, 2014, ERS had paid employees $1,535,745 of the $3,077,301 it awarded; $385,389 was due to be paid later in 2014, and $385,389 was due to be paid in 2015.
on the incentive compensation plan calculation methodology. The calculation errors were caused by use of incorrect formulas, incorrect weighting of plan inputs for individuals whose positions changed during the plan year, use of incorrect value inputs, and incorrect salary calculations.

- ERS used accurate amounts for the quantitative metric portion of its incentive compensation calculations. However, ERS did not consistently maintain source documentation for the quantitative metric that it used. Specifically, ERS did not maintain that documentation for 23 (38 percent) of the 61 participants in its incentive compensation plan. The ERS records retention schedule did not require ERS to maintain that documentation.

- The ERS board of trustees did not formally approve the 2013 incentive compensation plan prior to the beginning of the plan year. That increases the risk that the incentive compensation may not align with the intent of the board of trustees. The ERS board of trustees approved the 2014 incentive compensation plan prior to the start of that plan performance period.

Additional Incentive Compensation Plan Information

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

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

During the plan year, the ERS executive director used discretionary authority to expand the list of eligible incentive compensation plan participants to include legal staff and investment operations staff. The ERS board of trustees did not approve that change prior to the start of the plan year. See Appendix 3 for the details on the additional positions included in the incentive compensation plan.
Table 4 shows the positions eligible to earn incentive compensation under the ERS plan and the incentive compensation award range for each position for the 2013 plan year.

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

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

Source: ERS.
Recommendations

ERS should:

- Strengthen its review process for plan payment calculations and related documents to help ensure that payments align with plan policies and procedures and that payments are supported.

- Update its records retention schedule to require ERS to retain source documentation for all quantitative metrics it uses to calculate incentive compensation payments. Because the ERS incentive compensation plan is based on performance periods of different lengths (currently, five years, three years, and one year), ERS should retain that documentation for a length of time that is equal to its most lengthy performance period.

- Ensure that the ERS board of trustees formally approves the incentive compensation plan prior to the beginning of a plan year.

Management’s Response

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

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

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

Sufficient information has not been provided to ERS related to the Additional Incentive Compensation Plan Information section and associated 20 pages of individual personnel action forms included in appendices, to address any potential concerns and possible corrective action. No instance of non-compliance with the stated audit scope objective or any recommendations to
improve operations related to this section were reported. ERS’ Audit Committee Chair, through ERS’ Internal Audit Division, has extended an invitation to the State Auditor’s Office to present this report at the August 19, 2014 Audit Committee meeting to ensure any concerns are appropriately addressed by the ERS Audit Committee and Board of Trustees.

Auditor Follow-up Comment

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

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

Appendix 1
Objective, Scope, and Methodology

Objective

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

Scope

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

Methodology

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

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

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

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

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

Procedures and tests conducted included the following:

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

Criteria used included the following:

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

Audit fieldwork was conducted from February 2014 through April 2014. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

- Michael O. Clayton, CPA, CISA, CIDA, CFE (Project Manager)
- Ashlee C. Jones, MAcy, CFE, CGAP (Assistant Project Manager)
- Michelle Lea DeFrance, CPA
- Michelle Ann Duncan Feller, CPA, CIA (Quality Control Reviewer)
- Angelica M. Ramirez, CPA (Audit Manager)
Appendix 2

ERS Incentive Compensation Plan Excerpts Regarding Executive Director Discretion

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

7.2 All decisions of the Board or Executive Director, as applicable, shall be binding and conclusive on the Participants and ERS. Subject to the provisions of the Plan, the Board or Executive Director, as applicable, shall have the discretionary authority to:

(a) approve Participants of the Plan, including determining eligibility for Plan Participants;

(b) approve Plan Year Participant Goals, and all aspects of the calculations for computing Incentive Compensation Awards;

(c) evaluate the performance of the employees and recommend Incentive Compensation Awards;

(d) exercise discretion in payment of Incentive Compensation Awards as discussed in Sections 6;

(e) establish policies and procedures for the administration of the Plan;

(f) interpret the Plan and make all decisions necessary to administer the Plan; and

(g) delegate the authority to administer all or any part of the Plan to ERS employees that are not Participants in the Plan during the respective Plan Year.
This appendix presents Employees Retirement System memos regarding the inclusion of certain employees in that agency’s incentive compensation plan. The State Auditor’s Office redacted the names of the employees discussed in these memos.

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

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

Recommendation

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

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

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

Background

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

Investment Operations Staff Job Duties and Responsibilities

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

INTEROFFICE MEMORANDUM

DATE: July 31, 2012
TO: Ann S. Bishop, Executive Director
Larry Zaplin, Chief Operating Officer
THROUGH: Jacqueline Johnson, Deputy Executive Director of Investments
FROM: Betty Martin, Director of Investment Operations
SUBJECT: ELIGIBILITY FOR INVESTMENT OPERATIONS STAFF IN THE ERS INCENTIVE COMPENSATION PLAN FOR KEY INVESTMENT PROFESSIONALS AND LEADERSHIP EMPLOYEES ("ICP")

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

Recommendation

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

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

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

Background

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

Investment Operations Staff Job Duties and Responsibilities

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

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

By auditing the trade programs on a daily basis in both domestic and international markets, Investment Operations ensures that trades are not settled with terms other than those agreed upon between our traders and external brokers or are not properly authorized. This rigorous attention is critical to ensuring the Trust Fund’s assets are not subject to unnecessary loss and that other Investment Professionals have accurate data with which to make investment decisions. When reviewed with ERS’ prior custodian, it was determined that the trade settlement rate for ERS is 3.4% better than average rate for the custodian’s other similar clients. This metric not only speaks well of the Investment Operations team but also focuses on supporting ERS’ cost-savings and industry reputation.

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

Recommendation Aligned with ICP Goals

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

☐ APPROVED
☐ NOT APPROVED

Larry Zepplin 8/12/12
Ann S. Bishop 8/13/12

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

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

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

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

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

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

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

We all work diligently to take as many administrative burdens from the Investments’ staff as possible, in order for them to have time to research stocks and choose appropriate investments for ERS. Please review Exhibit B for a listing of the administrative tasks that we perform so that the Investments staff can spend their time on what they are trained and educated to do. However, if we understand that the goal of the ICP is to promote teamwork and employee retention consistent with other ICP Plans in the area, then we would urge you to consider our inclusion.
Memo RE: Inclusion in the ERS’ Investments Incentive Compensation Plan (ICP)
July 27, 2012
Page 2

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

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

[Signatures]

Larry Zeplin
Date

Ann S. Bishop
Date

I approve

I approve

8/28/12
Administrative Role in Processing Trades

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

When a trade is received the administrative staff:

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

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

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

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

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

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

Interoffice Memorandum

DATE: August 22, 2012

TO: Ann S. Bishop

FROM: Larry Zeplin

SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals –

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

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

- Performs advanced professional and complex legal work, advice and counsel involving regular contact with the Executive Director and Deputy Executive Director of Investments as well as with the legal staffs of the investment advisors, global custodian and other third party firms contracting with the Investments Division.

- Interprets, reviews and supervises negotiations of contracts and other legal documents, including limited partnerships and related documents involving private equity and real estate-related investments, investment advisors, including the development of requirements, specifications and contracts for investment and securities-related projects and other projects as requested.

- Advises and drafts policies and documents in connection with the management and investment of ERS funds; may counsel ERS staff on employment, securities and contract law; and may advise ERS on fiduciary, alternative investments and related issues.

[Redacted] has and will continue to exercise managing the negotiations of investment contracts, and [Redacted] has and will continue advising ERS executive management and Investments Division management regarding fiduciary duty, investment compliance, federal and state securities and investment-related laws and regulations and related contract matters.
Providing legal advice and support to and on behalf of the Investments Division is a critical function of the high-level, discretionary job responsibility of [Redacted], clearly related to the investment of ERS' assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS' assets. [Redacted] also provides crucial legal support to the Investments Division through [Redacted] role as Chief Compliance Officer.

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

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

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

Given the level of responsibility and oversight that [Redacted] has undertaken in connection with the provision of legal and compliance efforts for the Investments Division, I am requesting that [Redacted], as defined in the ICP, be 65% [Redacted] as range.

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

I Concur: [Signature] [Redacted] 8/22/12

Approved: [Signature] [Redacted] 8/28/12
Interoffice Memorandum

DATE: August 22, 2012 (revised from previously submitted memo June 13, 2012)

TO: Ann S. Bishop

THROUGH: Larry Zeplin

FROM: Paula A. Jones

SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals

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

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

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

[redacted] has and will continue to exercise discretion in drafting, reviewing and negotiating private placement memoranda, limited partnership agreements and related contracts, and [redacted] has and will continue advising ERS executive management and Investments Division management regarding investment compliance, federal and state securities and investment-related laws and regulations and related contract matters.
Providing legal advice and support to and on behalf of the Investments Division is a critical function of the high-level, discretionary job responsibility of [redacted], clearly related to the investment of ERS’ assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS’ assets. [redacted] also provides crucial legal support to the TexasSaver 401(k) and 457 programs, and [redacted] experience as a CPA and auditor has proven to be invaluable for ERS.

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

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

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Date of Hire</th>
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<th>Current Salary</th>
<th>Performance Goals</th>
<th>Percent of Award</th>
</tr>
</thead>
<tbody>
<tr>
<td>[redacted]</td>
<td>Investments and Securities, Attorney</td>
<td>01/07/08</td>
<td>09/01/2012</td>
<td>$151,000</td>
<td>75% Qualitative-Discretionary 25% Total Trust Fund Performance</td>
<td>50-65%</td>
</tr>
</tbody>
</table>

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

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

I Concur: [Signature]

Chief Operating Officer

Approved: [Signature]

Executive Director

Date: 8/22/12

Date: 8/28/12
DATE: August 22, 2012 (revised from previously submitted memo June 13, 2012)

TO: Ann S. Bishop

THROUGH: Larry Zeplin

FROM: Paula A. Jones

SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals - [Redacted]

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

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

- Performs advanced professional and complex legal work, advice and counsel involving regular contact with the General Counsel, Executive Director, Deputy Executive Director of Investments . . . as well as with the legal staffs of the investment advisors, global custodian . . .

- Drafts, interprets, reviews and negotiates contracts and other legal documents, including limited partnerships and related documents involving private equity and real estate-related investments, investment advisor, . . . involving the development of requirements, specifications and contracts for investment and securities-related projects and other projects as requested.

- Advises and drafts documents in connection with the management and investment of ERS funds; may counsel ERS staff on employment, securities and contract law; and may advise ERS on alternative investments and related issues.

[Redacted] has and will continue to exercise [Redacted] discretion in drafting, reviewing and negotiating private placement memoranda, limited partnership agreements and related contracts, and [Redacted] has and will continue advising ERS executive management and Investments Division management regarding corporate governance, federal and state securities and investment-related laws and regulations and related contract matters.
Providing legal advice and support to and on behalf of the Investments Division is: a critical function of the high-level, discretionary job responsibility of __________, clearly related to the investment of ERS’ assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS’ assets. __________ has also provided crucial legal support to the Texasaver 401(k) and 457 programs with regard to the addition of investment products, and private practice real estate experience has proven to be invaluable for ERS.

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

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

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Date of Hire</th>
<th>Effective Date of Plan Eligibility</th>
<th>Current Salary</th>
<th>Performance Goals</th>
<th>Percent of Award</th>
</tr>
</thead>
<tbody>
<tr>
<td>__________</td>
<td>Investments and Securities, Attorney</td>
<td>10/27/08</td>
<td>09/01/2012</td>
<td>$151,000</td>
<td>75% Qualitative-Discretionary</td>
<td>25% Total Trust Fund Performance</td>
</tr>
</tbody>
</table>

Given the outstanding performance that __________ has consistently exhibited in connection with __________’s provision of high-level investment-related legal services, I am requesting that __________’s “Maximum Incentive Award Percentage,” as defined in the ICP, be 55%. I am requesting that this memo serve to approve __________ for participation in the plan, based on the foregoing recommendations, for the 2013 Plan Year.

I Concur: ____________________________
Chief Operating Officer

Date: 8/22/12

Approved: ____________________________
Executive Director

Date: 8/28/12
DATE: August 22, 2012 (revised from previously submitted memo June 14, 2012)

TO: Ann S. Bishop

THROUGH: Larry Zeplin

FROM: Paula A. Jones

SUBJECT: Request for Addition to Incentive Compensation Plan for Investments Professionals

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

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

- Assists in the development, implementation and coordination of an agency-wide alternative investments program for ERS; researches, drafts, evaluates, revises and/or develops policies, procedures, guidelines, processes, systems and forms for the Investments Division.

- Reviews, drafts and revises investments-related contracts; under the supervision of ERS attorneys, directly negotiates with staff of investment advisors and other vendors; completes subscription agreements, know-your-client documentation in foreign jurisdictions, and other private investment documentation.

- Serves as liaison between . . . staff attorneys and Deputy Executive Director of Investments as needed; advises and interacts with the General Counsel and the Executive Director, as needed; provides assistance to attorneys and participates in planning, coordination and execution of transaction closings; manages closing documents and distribution of document sets following deal closings; reviews transaction closing binders to ensure completeness and accuracy.

- Coordinates information gathering from various departments to ensure accuracy of the provisions of deal-related contracts and other legal documents; maintains complex records of a confidential nature; assists with open records requests related to investment contracts and transactions.
• Explains previously interpreted laws, rules and regulations to the Investments Division; researches and provides legal analysis of statutes, case law, administrative records and opinions.

[Redacted] assists [Redacted] and [Redacted] with drafting, reviewing and negotiating limited partnership agreements and other investment contracts. [Redacted] has approximately 15 years of experience as a paralegal, specializing in securities laws and corporate transactions. Providing support to and on behalf of the Investments Division is a critical function of the job duties of [Redacted] that is necessary to enable staff of the Investments Division to perform the prudent investment of ERS’ assets.

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

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

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Date of Hire</th>
<th>Effective Date of Plan Eligibility</th>
<th>Current Salary</th>
<th>Performance Goals</th>
<th>Percent of Award</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Redacted]</td>
<td>Investments and Securities, Paralegal</td>
<td>10/06/08</td>
<td>09/01/2012</td>
<td>$82,907</td>
<td>90% Qualitative-Discretionary, 10% Total Trust Fund Performance</td>
<td>20-35%</td>
</tr>
</tbody>
</table>

Given the outstanding performance that [Redacted] has consistently exhibited in connection with [Redacted] provision of high-level discretionary investment-related paralegal services, I am requesting that [Redacted] “Maximum Incentive Award Percentage,” as defined in the ICP, be 25%. Keep a copy.

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

I Concur: [Signature]
Chief Operating Officer

Date

Approved:
[Redacted] Executive Director

Date
An Audit Report on Incentive Compensation at
The Teacher Retirement System, the Permanent School Fund, the General Land Office, and the Employees Retirement System
SAO Report No. 14-033
May 2014
Page 38
Providing legal advice and support to and on behalf of the Investments Division is a critical function of the high-level, discretionary job responsibility of [redacted], clearly related to the investment of ERS’ assets, and necessary to enable staff of the Investments Division to perform the prudent investment of ERS’ assets.

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

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

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Date of Hire</th>
<th>Effective Date of Plan Eligibility</th>
<th>Current Salary</th>
<th>Performance Goals</th>
<th>Percent of Award</th>
</tr>
</thead>
<tbody>
<tr>
<td>[redacted]</td>
<td>Investments and Securities, Attorney</td>
<td>01/07/13</td>
<td>02/01/2013</td>
<td>$140,000</td>
<td>75% Qualitative-Discretionary 25% Total Trust Fund Performance</td>
<td>50-65%</td>
</tr>
</tbody>
</table>

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

I Concur: [Signature] 7/14/13

Approved: [Signature] 7/16/13
Copies of this report have been distributed to the following:

**Legislative Audit Committee**
The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Harvey Hilderbran, House Ways and Means Committee

**Office of the Governor**
The Honorable Rick Perry, Governor

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  - Mr. Frederick E. Rowe, Jr., Vice Chair
  - Ms. Cydney Donnell
  - Ms. Yolanda Griego
  - Mr. I. Craig Hester
  - Ms. Cheryl MacBride
  - Ms. Ann S. Bishop, Executive Director

**General Land Office**
The Honorable Jerry Patterson, Land Commissioner and Chairman of the School Land Board
Members of the School Land Board
  - Mr. David S. Herrmann
  - Mr. Thomas Orr, Jr.

**Permanent School Fund**
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  - Mr. Thomas Ratliff, Vice Chair
  - Ms. Mavis B. Knight, Secretary
  - Mr. Lawrence A. Allen, Jr.
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  - Mr. David Bradley
  - Mr. Ruben Cortez, Jr.
  - Dr. Martha M. Dominguez
  - Ms. Patricia Hardy
  - Mr. Tom Maynard
  - Mr. Ken Mercer
  - Ms. Sue Melton-Malone
  - Ms. Geraldine Miller
  - Ms. Marisa B. Perez
  - Mr. Marty Rowley
  - Mr. Michael L. Williams, Commissioner of Education, Texas Education Agency
  - Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Permanent School Fund
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Members of the Teacher Retirement System Board of Trustees
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   Mr. Brian Guthrie, Executive Director