AGENDA

A SPECIAL MEETING OF THE AUDIT COMMITTEE

OF THE BOARD OF RETIREMENT AND BOARD OF INVESTMENTS*

LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION

300 N. LAKE AVENUE, SUITE 810, PASADENA, CALIFORNIA 91101

9:00 A.M., WEDNESDAY, SEPTEMBER 12, 2018**

***Although the meeting is scheduled for 9:00 a.m., it is anticipated that the meeting will start at the conclusion of the Board of Investments and Board of Investment Committee scheduled for the same time.*

2018 AUDIT COMMITTEE MEMBERS
Michael S. Schneider, Chair
Vivian Gray, Vice Chair
Herman Santos, Secretary
David Green
Shawn R. Kehoe
Joseph Kelly

AUDIT COMMITTEE CONSULTANT
Rick Wentzel

I. CALL TO ORDER

II. APPROVAL OF MINUTES

A. Approval of the Minutes of the Regular Audit Committee Meeting of March 21, 2018.

B. Approval of the Minutes of the Regular Audit Committee Meeting of July 18, 2018.

III. PUBLIC COMMENT

IV. NON-CONSENT ITEMS

A. Recommendation as submitted by Leisha Collins, Principal Internal Auditor: That the Committee approve the Audit Plan for Fiscal Year End 2019. (Memo dated August 31, 2018)

B. Recommendation as submitted by Leisha Collins, Principal Internal Auditor: That the Committee review and discuss the Securities Lending Program and take the following action(s):

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff.

(Memo Dated on August 31, 2018)

C. Recommendation as submitted by Leisha Collins, Principal Internal Auditor: That the Committee review and discuss the Tier II Retiree Healthcare Program report and take the following action(s):

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff.

(Memo Dated on August 31 2018)

D. Recommendation as submitted by Leisha Collins, Principal Internal Auditor: That the Committee review and discuss the Contract Monitoring Program Status Update report and take the following action(s):

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff.

(Memo Dated on August 31, 2018)

V. CONSULTANT COMMENTS

VI. REPORT ON STAFF ACTION ITEMS

VII. GOOD OF THE ORDER
(For information purposes only)

VIII. ADJOURNMENT

The Board of Retirement and Board of Investments have adopted a policy permitting any member of the Boards to attend a standing committee meeting open to the public. In the event five (5) or more members of either the Board of Retirement and/or the Board of Investments (including members appointed to the Committee) are in attendance, the meeting shall constitute a joint meeting of the Committee and the Board of Retirement and/or Board of Investments. Members of the Board of Retirement and Board of Investments who are not members of the Committee may attend and participate in a meeting of a Board Committee but may not vote on any matter discussed at the meeting. Except as set forth in the Committee's Charter, the only action the Committee may take at the meeting is approval of a recommendation to take further action at a subsequent meeting of the Board.

*****Although the meeting is scheduled for 9:00 a.m., it can start anytime thereafter, depending on the length of the Board of Investment meeting and Committees preceding it. Please be on call.***

Documents subject to public disclosure that relate to an agenda item for an open session of the Board and/or Committee that are distributed less than 72 hours prior to the meeting will be available for public inspection at the time they are distributed to a majority of the members of any such Board and/or Committee at LACERA's offices at 300 N. Lake Avenue, Suite 820, Pasadena, CA 91101 during normal business hours [e.g., 8:00 a.m. to 5:00 p.m. Monday through Friday].

Persons requiring an alternative format of this agenda pursuant to Section 202 of the Americans with Disabilities Act of 1990 may request one by calling Cynthia Guider at (626)-564-6000 extension 3327, from 8:00 a.m. to 5:00 p.m. Monday through Friday, but no later than 48 hours prior to the time the meeting is to commence. Assistive Listening Devices are available upon request. American Sign Language (ASL) Interpreters are available with at least three (3) business days notice before the meeting date.

MINUTES OF THE MEETING OF THE AUDIT COMMITTEE OF THE

BOARD OF RETIREMENT AND BOARD OF INVESTMENTS*

LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION

300 N. LAKE AVENUE, SUITE 810, PASADENA, CA

9:00 A.M., WEDNESDAY, MARCH 21, 2018

PRESENT: Michael S. Schneider, Chair

Vivian Gray, Vice Chair

Herman Santos, Secretary

David Green

ABSENT: Joseph Kelly

Shawn R. Kehoe

STAFF, ADVISORS, PARTICIPANTS

Richard Bendall, Chief Audit Executive

Steven P. Rice, Chief Legal Counsel

Rick Wentzel, Audit Committee Consultant

Quoc Nguyen, Principal Internal Auditor

Christina Logan, Senior Internal Auditor

Gabriel Tafoya, Senior Internal Auditor

Kathryn Ton, Senior Internal Auditor

Tamara Caldwell, Disability Retirement Specialist Supervisor

James Brekk, Interim Chief Deputy

I. CALL TO ORDER

The meeting was called to order at 9:06 a.m., in the Board Room of Gateway Plaza.

II. APPROVAL OF THE MINUTES

A. Approval of the Minutes of the Regular Meeting of November 30, 2017

Mr. Green made a motion, Mr. Santos seconded, to approve the minutes of the regular meeting of November 30, 2017. The motion passed unanimously.

III. PUBLIC COMMENT

There were no requests from the public to speak.

IV. NON-CONSENT AGENDA

A. Recommendation as submitted by Richard Bendall, Chief Audit Executive: That the Committee review the Audit Committee Meeting Schedule and provide direction to staff on changes. (Memo Dated on March 1, 2018)

Mr. Santos made a motion, Ms. Gray seconded, to approve staff's recommendation. The motion passed unanimously.

B. Recommendation as submitted by Richard Bendall, Chief Audit Executive, Leisha Collins, Principal Internal Auditor, and Christina Logan, Senior Internal Auditor: That the Committee:

1. Provide direction to staff on the proposed updates to the Audit Committee Charter, and

2. Upon approval, recommend to the Board of Retirement and Board of Investments to adopt the revised Audit Committee Charter.
(Memo Dated on March 1, 2018)

IV. NON-CONSENT AGENDA (Continued)

Mr. Santos made a motion, Ms. Gray seconded, to adopt the revised Audit Committee Charter recommendation. The motion passed unanimously.

C. Recommendation as submitted by Richard Bendall, Chief Audit Executive: That the Committee review and discuss the Retiree Healthcare Benefits Program Funding Audit engagement report and take the following action(s):

1. Accept and file report and/or,

2. Instruct staff to forward report to Boards or Committees and/or,

3. Provide further instruction to staff. (Memo Dated on March 1, 2018)

Kathryn Ton was present to answered questions from the Committee.

Mr. Santos made a motion, Mr. Green seconded, to accept and file the report. The motion passed unanimously.

D. Recommendation as submitted by Richard Bendall, Chief Audit Executive: That the Committee review and discuss the External Penetration Test engagement report and take the following action(s):

1. Accept and file report and/or,

2. Instruct staff to forward report to Boards or Committees and/or,

3. Provide further instruction to staff. (Memo Dated on March 1, 2018)

Mr. Santos made a motion, Mr. Green seconded, to accept and file the report. The motion passed unanimously.

IV. NON-CONSENT AGENDA (Continued)

E. Recommendation as submitted by Richard Bendall, Chief Audit Executive: That the Committee review and discuss the Data Backup and Retention engagement report to take the following action(s):

1. Accept and file report and/or,

2. Instruct staff to forward report to Boards or Committees and/or,

3. Provide further instruction to staff. (Memo Dated on March 1, 2018)

Mr. Santos made a motion, Mr. Green seconded, to accept and file the report. The motion passed unanimously.

F. Recommendation as submitted by Richard Bendall, Chief Audit Executive: That the Committee review and discuss the Physician Selection, Monitoring, and Compensation Audit engagement report and take the following action(s):

1. Accept and file report and/or,

2. Instruct staff to forward report to Boards or Committees and/or,

3. Provide further instruction to staff. (Memo Dated on March 1, 2018)

Christina Logan, Tamara Caldwell, and James Brekk were present to answer questions from the Committee.

Mr. Santos made a motion, Mr. Green seconded, to accept and file report. The motion passed unanimously.

V. REPORT

A. Internal Audit Risk Assessment Report
Richard Bendall, Chief Audit Executive
(Memo Dated on March 1, 2018)

Mr. Bendall was present and answered questions from the Committee. This report was received and filed.

V. REPORT (Continued)

B. Audit Plan Status Report
Richard Bendall, Chief Audit Executive
(Report Updated on March 1, 2018)

Mr. Bendall was present and answered questions from the Committee. This report was received and filed.

C. Recommendation Follow-Up Report
Quoc Nguyen, Principal Internal Auditor
(Report Updated on March 1, 2018)

Messrs. Nguyen and Tafoya were present and answered questions from the Committee. This report was received and filed.

D. Attorney-Client Privilege/Confidential Memo
Privacy Audit Recommendation Follow-Up
Steven Rice, Chief Legal Counsel
Richard Bendall, Chief Audit Executive (Memo Dated on March 1, 2018)

Messrs. Bendall and Rice were present and answered questions from the Committee.

E. Attorney-Client Privilege/Confidential Memo
Human Resources Compliance Audit [by Liebert Cassidy Whitmore]
Steven Rice, Chief Legal Counsel
Richard Bendall, Chief Audit Executive
(Memo Dated on March 1, 2018)

Mr. Bendall was present and answered questions from the Committee.

F. Status of Other External Audits Not Conducted at the Discretion of Internal Audit
Richard Bendall, Chief Audit Executive
(Verbal Presentation)

Mr. Bendall was present and answered questions from the Committee.

V. REPORT (Continued)

G. Internal Audit Goal Report
Richard Bendall, Chief Audit Executive
(Updated on March 1, 2018)

Mr. Bendall was present and answered questions from the Committee.

VI. REPORT ON STAFF ACTION ITEMS

There was nothing to report.

VII. GOOD OF THE ORDER
(For information purposes only)

Committee members thanked staff for their hard work.

VIII. ADJOURNMENT

There being no further business to come before the Committee, the meeting was adjourned at 10:50 a.m.

MINUTES OF THE REGULAR MEETING OF THE AUDIT COMMITTEE OF THE

BOARD OF RETIREMENT AND BOARD OF INVESTMENTS*

LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION

300 N. LAKE AVENUE, SUITE 810, PASADENA, CA

9:00 A.M., WEDNESDAY, JULY 18, 2018

PRESENT: Michael S. Schneider, Chair

Vivian Gray, Vice Chair

Herman Santos, Secretary

ABSENT: David Green

Shawn R. Kehoe

Joseph Kelly

STAFF, ADVISORS, PARTICIPANTS

Steven P. Rice, Chief Legal Counsel

Rick Wentzel, Audit Committee Consultant

Quoc Nguyen, Principal Internal Auditor

Leisha Collins, Principal Internal Auditor

Christina Logan, Senior Internal Auditor

Gabriel Tafoya, Senior Internal Auditor

Kathryn Ton, Senior Internal Auditor

I. CALL TO ORDER

The meeting was called to order at 9:04 a.m., in the Board Room of Gateway Plaza. Due to a lack of a quorum no action was taken during the Committee meeting.

II. APPROVAL OF THE MINUTES

A. Approval of the Minutes of the Regular Meeting of March 21, 2018.

This agenda item was moved to the next Internal Audit Committee Meeting.

III. PUBLIC COMMENT

There were no requests from the public to speak.

IV. NON-CONSENT AGENDA

A. Recommendation as submitted by Leisha Collins, Principal Internal Auditor and Quoc Nguyen, Principal Internal Auditor: That the Committee approve the Audit Plan for Fiscal Year End 2019.

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff. (Memo Dated on July 5, 2018)

Leisha Collins, Quoc Nguyen, Roxana Castillo, Robert Hill, Bernardo Buenaflor, Derwin Brown were present to answer questions from the Committee.

This Agenda item was moved to the next Internal Audit Committee Meeting.

IV. NON-CONSENT AGENDA (Continued)

B. Recommendation as submitted by Quoc Nguyen, Principal Internal Auditor: That the Committee review and discuss the Securities Lending Program and take the following action(s):

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff. (Memo Dated on July 5, 2018)

Quoc Nguyen, Kathryn Ton, Vache Mahseredjian, were present to answer questions from the Committee.

This Agenda item was moved to the next Internal Audit Committee Meeting.

C. Recommendation as submitted by Quoc Nguyen, Principal Internal Auditor: That the Committee review and discuss the Tier II Retiree Healthcare Program report and take the following actions(s):

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff. (Memo Dated on July 5, 2018)

This Agenda item was moved to the next Internal Audit Committee Meeting.

D. Recommendation as submitted by Quoc Nguyen, Principal Internal Auditor: That the Committee review and discuss the Contract Monitoring Program Status Update report and take the following action(s):

1. Accept and file report and/or,
2. Instruct staff to forward report to Boards or Committees and/or,
3. Provide further instruction to staff. (Memo Dated on July 5, 2018)

Quoc Nguyen, Roxana Castillo, Robert Hill, John Nogales were present to answer questions from the Committee.

This Agenda item was moved to the next Internal Audit Committee Meeting.

V. REPORTS

A. Audit Plan Staffing Report
Leisha Collins, Principal Internal Auditor
Quoc Nguyen, Principal Internal Auditor
(Report Updated on July 5, 2018)

Leisha Collins, Quoc Nguyen, Roxana Castillo, Robert Hill, Bernardo Buenaflor, Derwin Brown, John Nogales were present to answer questions from the Committee.

B. Status of Other External Audits Not Conducted at the Discretion of Internal Audit
Leisha Collins, Principal Internal Auditor
(For Information Only) (Discussion)

C. Internal Audit Annual Report – Fiscal Year End 2018
Leisha Collins, Principal Internal Auditor
(For Information Only) (Memo dated July 5, 2018)

D. Internal Audit Goal Report
Leisha Collins, Principal Internal Auditor
(For Information Only) (Memo dated July 2, 2018)

E. Recommendation Follow-Up Report
Leisha Collins, Principal Internal Auditor
Gabriel Tafoya, Senior Internal Auditor
(For Information Only) (Memo dated July 5, 2018)

F. Privacy Audit Recommendation Follow-Up
Leisha Collins, Principal Internal Auditor
Christina Logan, Senior Internal Auditor
(For Information Only) (Memo dated July 10, 2018)

G. Human Resources Compliance Audit [by Liebert Cassidy Whitmore] Recommendation Follow-Up
Leisha Collins, Principal Internal Auditor
(For Information Only) (Memo dated June 29, 2018)

VI. REPORT ON STAFF ACTION ITEMS

Mr. Santos recommended that the Internal Audit Staff prioritize the Board and Staff Travel Policy.

Mr. Santos recommended that Leisha Collins follow up on the staffing needs of the Internal Audit Department.

VII. GOOD OF THE ORDER
(For information purposes only)

Committee members thanked staff for their hard work.

VIII. ADJOURNMENT

There being no further business to come before the Committee, the meeting was adjourned at 10:04 a.m.

L//.CERA

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Leisha Collins
Principal Internal Auditor

FOR: September 12, 2018 Audit Committee Meeting

SUBJECT INTERNAL AUDIT PLAN - FISCAL YEAR END 2019

RECOMMENDATION
Approve the proposed Internal Audit Plan for Fiscal Year End 2019.

BACKGROUND
According to the Institute of Internal Auditors *(IIA) International Standards for the Professional practice of Internal Auditing (Standards)*, the Chief Audit Executive *(CAE)* must establish risk-based plans to determine the priorities of the internal audit activity and ensure consistency with the organization's goals. To remain in compliance with the *Standards*, as well as the Audit Committee Charter, Internal Audit has developed the attached Internal Audit Plan *(Audit Plan)* for Fiscal Year End *(FYE)* 2019.

The Audit Plan ensures audit resources are appropriately allocated to address identified top priorities and key risk areas. It is broken out by category as follows: Management Governance, Information Systems, Benefits Administration, or Financial & Investment Operations.

In considering the Audit Plan for FYE 2019, we remind your Committee that the Audit Plan is intended as a living document to allow changes to its content and schedule as a result of ongoing changes to risk factors, organizational needs, or resource limitations. For expediency, the CAE will approve changes to the Audit Plan, and provide information regarding changes to the Audit Plan, at each Committee Meeting during the fiscal year.

PURPOSE

The purpose of the Audit Plan is to justify support for audit resources and establish priorities for the work performed by the Internal Audit Division. Furthermore, the Audit Plan provides a basis for measuring Internal Audit's accomplishments and supplies a guide to external auditors and others of the planned internal audit coverage. Most importantly, the Audit Plan helps to ensure audit resources are allocated to address identified top priorities.

RISK ASSESSMENT AND AUDIT PLANNING

The projects included in our Audit Plan are primarily identified through our on-going risk assessment process. This process includes keeping abreast of the concerns of the Audit Committee and Boards throughout the year, review of LACERA's Strategic Plan, and risk meetings with the Executive Office, division managers and staff. We also included projects from our FYE 2018 Audit Plan that were either in progress or did not begin prior to June 30, 2018.

We continue to allocate resources towards internal administration projects such as updating our Internal Audit Guide Book. We believe that this will help streamline our audit processes and ultimately result in higher quality audits and the completion of more projects**.** A big project on our plan this year is to spearhead the organization-wide Fiduciary Audit, which will be a comprehensive assessment by an independent third party of how well LACERA is meeting its governance and oversight responsibilities as well the effectiveness of its operations. Below summarizes our proposed FYE 2019 Audit Plan.

AUDIT PARTICIPATION AREAS:

As indicated on our proposed FYE 2019 Audit Plan below, we've included 33 total projects:

- 9 Projects rolled-over from the FYE 2018 Audit Plan that are near completion
- 5 Projects rolled-over from the FYE 2018 Audit Plan that will begin in FYE 2019
- 16 New and ongoing (including periodic and annual) projects
- 3 Administrative projects designed to improve audit operations

As organizational needs, conditions, resources, and priorities change, Internal Audit Management will use its professional judgment as to the order in which audit projects are addressed. Staff will focus on efficiency and effectiveness in performing work to make every effort to complete the 33 projects included in this Audit Plan. The Audit Plan includes estimated hours for each section of the audit plan; actual hours for each project will be determined at the start of each project based on the final scope and audit approach. Attachment A includes a brief description of each audit area.

RECOMMENDATION

Should your Committee agree with staff's recommendation, appropriate action would be to:

1. Approve the proposed Internal Audit Plan for Fiscal Year End 2019

INTERNAL AUDIT PLAN FYE 2019

The following table provides a list of the planned Internal Audit projects for the **Fiscal Year End 2019.**

PROJECT	STATUS	TYPE	FREQUEQY
MANAGEMENT, GOVERNANCE & COMPLIANCE			**Est. Hours: 3500**
1. Fiduciary Review		Ext. Audit	Planned
2. Board and Staff Travel*		Audit	Planned
3. Corporate Credit Card Audit*		Audit	Planned
4. Inventory Controls	In Progress	Audit	Planned
5. Timecard Review		Audit	Planned
6. Continuous Auditing Program		Audit	Ongoing
7. Pensionable Pay Code Testing		Audit	Periodic
8. 960 Hours Testing		Audit	Periodic
9. Privacy Audit Recommendation Coordination		Consulting	Planned
10. Compliance Committee		Consulting	Ongoing
11. Business Continuity/Disaster Recovery	In Progress	Consulting	Planned
12. Risk Assessment – FYE 2020		Admin	Annual
13. Internal Audit Guide Book Updates		Admin	Planned
14. Internal Audit Fraud Hotline		Admin	Planned
BENEFITS ADMINISTRATION			**Est. Hours: 1200**
15. Benefits' Exception Report Review Process	In Progress	Audit	Planned
16. Active Death Process Follow Up*		Audit	Planned
17. Death Legal Process		Audit	Planned
18. Foreign Payee Audit		Audit	Planned
19. Member Account Settlement Process	In Progress	Audit	Planned
INFORMATION SYSTEMS			**Est. Hours: 2100**
20. IT Risk Assessment Follow-Up	In Progress	Consulting	Planned
21. Member Applications Change Control	In Progress	Audit	Planned
22. External Penetration Testing		Ext. Audit	Planned
23. Database Review		Audit	Planned
24. Management Project Review		Audit	Planned
FINANCIAL & INVESTMENT OPERATIONS			**Est. Hours: 2400**
25. External Financial Audit Oversight		Ext. Audit	Ongoing
26. THC Real Estate Audits Oversight		Ext. Audit	Ongoing
27. Actuarial Services Oversight		Consulting	Ongoing
28. Foreign Tax Reclamation Oversight	In Progress	Audit	Planned
29. Wire Transfers Audit	In Progress	Audit	Planned
30. THC Tax Liability Review		Consulting	Planned
31. Real Estate Investment Operations*		Ext. Audit	Planned
32. Real Estate Advisor Audits[1]	In Progress	Ext. Audit	Planned
33. Custodial Bank Risk Assessment*		Audit	Planned
			Total Hours: 9200

**An audit that was rolled over from FYE 2018 Audit Plan that will commence in FYE 2019.*

[1] Includes audits of Advisors managing debt program.

Attachment A

AUDIT PLAN FYE 2019

The following table provides a description of each audit area included in the FYE 2019 Audit Plan.

	PROJECT	DESCRIPTION
		MANAGEMENT, GOVERNANE & COMPLIANCE
1.	Fiduciary Review	Fiduciary Review, conducted by an independent third party, to assess how well LACERA is meeting its governance and oversight responsibilities as well the effectiveness of its operations.
2.	Board and Staff Travel Audit	Audit of Board and staff travel to ensure that expenses are in compliance with the LACERA Travel Policy.
3.	Corporate Credit Card Audit	Audit of staff's credit card usage to verify compliance with LACERA's credit card and purchasing polices.
4.	Inventory Controls	Review of management's inventory process for completeness and efficiency.
5.	Timecard Review	Audit of staff timecards and review organization-wide timekeeping controls to assess the accuracy of time reported and effectiveness of controls.
6.	Continuous Auditing Program	Automated testing of LACERA transactions and information systems. It is performed to provide assurance that LACERA is in compliance with applicable laws and regulations as well as internal policies and procedures.
7.	Pensionable Pay Code Testing	Periodic testing of plan sponsors' pay codes to ensure that codes are in compliance with the Board of Retirement determination on pensionability.
8.	960 Hours Testing	Audit of rehired retirees to determine if retirees are rehired and working in compliance with PEPRA and LACERA's Board policies.
9.	Privacy Audit Reco. Coordination	Oversee and coordinate the implementation of recommendations as stated in the external Privacy Audit final report.
10.	Compliance Committee	Participate in the Compliance Program Steering Committee in developing a framework for LACERA's formal compliance program.
11.	Business Continuity/ Disaster Recovery	Consult with management in updating and enhancing LACERA's Business Continuity/Disaster Recovery Program.
12.	Risk Assessment – FYE 2020	Assess risks and controls throughout the organization to plan for LACERA's overall audit needs and to develop the Audit Plan.
13.	Update Internal Audit Guide Book Updates	Update Internal Audit's Operation Guide, specifically in the audit report writing standards section.
14.	Internal Audit Fraud Hotline	Update the Internal Audit Fraud Hotline to incorporate best practices into the process.

	BENEFITS ADMINISTRATION	
15.	Benefits' Exception Report Review	Review of LACERA's process for reviewing and managing exception reports related to Benefits data and transactions.
16.	Active Death Process Follow Up	Review of Active Death case management in Benefits and Member Services, and follow-up of previous audit recommendations.
17.	Death Legal Process	Assessment of the Benefits Division's internal controls for processing member death and legal split cases.
18.	Foreign Payee Audit	Audit to confirm the living status of retirees living abroad.
19.	Member Account Settlement Process	Review of the Member Account Settlements Process to provide assurance that controls are functioning as intended.
	INFORMATION SYSTEMS	
20.	IT Risk Assessment Follow-Up	Follow-up on the implementation of recommendations from the IT Risk Assessment conducted during FYE 2018.
21.	Member Applications Change Control	Testing of current operating procedures and processes for changing or creating new membership application programs.
22.	External Pen. Testing	External Network Penetration testing, performed by external firm, to assess the security of the internet accessible Member Portal.
23.	Database Review	Review of Microsoft Access databases to facilitate member transactions and benefits processes. Also, to assess management controls to prevent process disruptions in case a database fails.
24.	Management Project Review	Assessment of the implementation of LACERA Systems to meet business objectives.
	FINANCIAL & INVESTMENT OPERATIONS	
25.	External Financial Audit Oversight	Internal Audit manages the relationship with the LACERA Annual Financial Auditors to facilitate the annual financial statement audit.
26.	THC Real Estate Audits Oversight	Internal Audit manages the relationship with the Real Estate External Auditors and oversees the audit engagements.
27.	Actuarial Services Oversight	Internal Audit manages the relationship with the Actuarial Consultant and Auditor for services relating to actuarial projects.
28.	Foreign Tax Reclamation Oversight	Internal Audit Oversees the external audit of LACERA's foreign tax withholding reclaim process.
29.	Wire Transfers Audit	Audit of wire transfers to assess LACERA's internal controls for setting up and transacting wire transfers to outside parties.
30.	THC Tax Liability Review	Review, conducted with tax consultant, to assessing tax reporting requirements of THC real estate investments.
31.	Real Estate Inv. Operations	Review of the Real Estate Investment Operations to provide assurance that controls exist and are functioning as intended.
32.	Real Estate Advisor Audits	Contract compliance and operational review of LACERA's Real Estate Advisors.
33.	Custodial Bank Risk Assessment	Contract compliance and operational review of custodial bank services

L//.CERA

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Leisha Collins
Principal Internal Auditor

FOR: September 12, 2018 Audit Committee Meeting

SUBJECT: **Securities Lending Program**

RECOMMENDATION

In accordance with your current Audit Committee Charter, staff recommends that the Audit Committee review and discuss the following engagement report to take the following action(s):

1. **accept and file report and/or,**
2. **instruct staff to forward report to Boards or Committees and/or,**
3. **provide further instruction to staff.**

ENGAGEMENT REPORTS

a. Securities Lending Program
Kathryn Ton, Senior Internal Auditor
(Report issued: May 30, 2018)

Please note: attached to the report is another version of the report that includes questions and comments that staff received from your Committee as well as Internal Audit's responses.

Attachments

LACERA INTERNAL AUDIT DIVISION

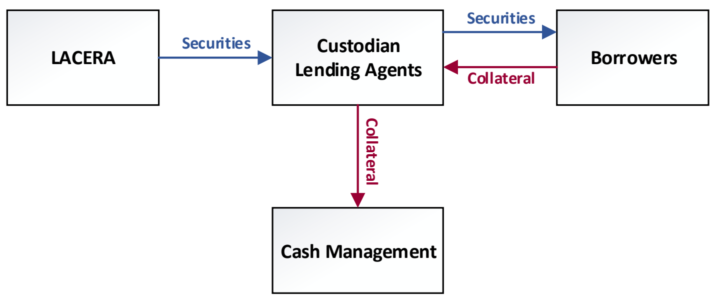
Securities Lending Program

May 30, 2018

AUDIT PERFORMED BY:
Kathryn Ton, CPA, CFE
Senior Internal Auditor

EXECUTIVE SUMMARY

We reviewed LACERA's securities lending program as part of the fiscal year 2018 audit plan. LACERA's Investments Office is responsible for the proper management and monitoring of the securities lending program. State Street Bank and Goldman Sachs are lending agents to the program, and make investment decisions on LACERA's behalf. LACERA's earnings from the securities lending program are used to fund the benefits of 165,000 LACERA members. The purpose of this audit is to assess whether LACERA and the lending agents are in compliance with key provisions of the Securities Lending Agency Agreements ("SLAA"), as noted in the audit objectives on page 6 and Table A on page 8 of the report. The diagram below illustrates the process flows between the parties involved when administering the program.



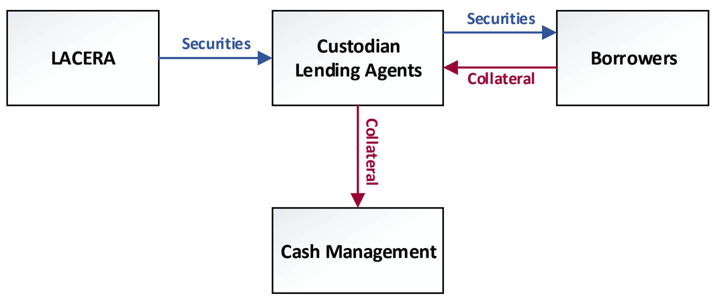
The securities lending program is intended to generate incremental returns to offset administrative expenses at a manageable level of risk. For fiscal year 2017, LACERA had an investment portfolio of $14.2 billion in lendable securities, $1.4 billion of which were loaned to qualified borrowers. At a 10% utilization rate, one-tenth of LACERA's fixed income and public equities portfolio were out on loan. LACERA generated $6.8 million from the program, net of fees.

Based on our review, Internal Audit found the lending agents to be in compliance with the key SLAA provisions reviewed, and the related controls to be effective and functioning as intended. Specifically, we noted that the lending agents have adequate controls to loan securities to approved borrowers in the SLAA. In addition, there are automated systems and management oversight to ensure that the loans are collateralized at or above the contractual requirements. Moreover, the cash collateral was tested against the investment guidelines, and we did not note any exceptions. Lastly, we noted good controls in the income splits between LACERA and the lending agents to ensure compliance with the terms in the SLAA. We made two recommendations to the Investments Office for strengthening their oversight over the Program: (1) review and update the SLAA, and (2) assess the lending agents' service fees. The details of our observations and recommendations are addressed in the report. We thank the Investments Office, State Street Bank, and Goldman Sachs for their assistance and cooperation with this audit.

SECURITIES LENDING PROGRAM

INTRODUCTION

We reviewed LACERA's securities lending program as part of the fiscal year 2018 audit plan. LACERA's Investments Office is responsible for the proper management and monitoring of the securities lending program. State Street Bank and Goldman Sachs are lending agents to the program, and make investment decisions on LACERA's behalf. LACERA's earnings from the securities lending program are used to fund the benefits of 165,000 LACERA members. The purpose of this audit is to assess whether LACERA and the lending agents are in compliance with key provisions of the Securities Lending Agency Agreements ("SLAA"), as noted in the audit objectives on page 6 and Table A on page 8 of the report. The diagram below illustrates the process flows between the parties involved when administering the program.



The securities lending program is intended to generate incremental returns to offset administrative expenses at a manageable level of risk. For fiscal year 2017, LACERA had an investment portfolio of $14.2 billion in lendable securities, $1.4 billion of which were loaned to qualified borrowers. At a 10% utilization rate, one-tenth of LACERA's fixed income and public equities portfolio were out on loan. LACERA generated $6.8 million from the program, net of fees.

BACKGROUND

LACERA has been administering the securities lending program under the direction of the Board of Investments. Since the program has been established, LACERA has delegated responsibilities to lending agents that specialize in securities lending services. LACERA's securities lending program is managed by its custodian bank, State Street Bank and Trust Company ("SSB"), and a third-party lending agent, Goldman Sachs Agency Lending ("GSAL"). SSB's investment management team, State Street Global Advisors ("SSgA"), invests the cash collateral received from both lending programs. The table below summarizes LACERA's securities lending program structure.

Securities Lending Program Structure			
Lending Agent	Cash Management	Collateral Accepted	Securities Type
SSB	SSgA	Cash and non-cash	International Equities US Treasuries and US Agencies
GSAL	SSgA	Cash only	Domestic Equities Corporate Bonds

In securities lending, LACERA will loan securities to borrowers in exchange for collateral. Collateral can be in the form of cash or non-cash securities, and is at least 102% of the market value of the securities on loan. Income from securities lending is generated through (1) non-cash collateral fees and (2) cash collateral reinvestment. LACERA charges borrowers a fee for the non-cash collateral received as payment for the loan. Conversely, LACERA pays borrowers interest for the cash collateral received. However, the cash collateral is reinvested in short-term investments to generate a higher return than the interest paid to borrowers. When borrowers terminate the loan and return the securities, LACERA returns the collateral with interest – this is known as the rebate. Earnings in excess of the rebate are divided between LACERA and the lending agents on a pre-determined basis, based on the income splits negotiated in the SLAA.

Investment Earnings		
Lending Agent	LACERA Split	Lending Agent Split
SSB	85%	15%
GSAL	87%	13%

SECURITIES LENDING PROGRAM RISKS

While securities lending is generally a low-risk investment program, there are three main risks associated with securities lending: (1) borrower default risk, (2) collateral reinvestment risk and (3) operational risk. We discuss each risk below and the mitigating controls necessary to administer an effective securities lending program.

BORROWER DEFAULT RISK

One risk that LACERA considers is the credit or borrower risk – namely, the risk that borrowers will go bankrupt and not return the securities on loan. LACERA and the lending agents have a three-step approach to mitigate this risk. First, lending agents must undertake a formal process for evaluating the credit of each borrower before and after including them on the approved borrowers list. Second, LACERA requires borrowers to pledge collateral over and above the value of the lent securities to absorb potential losses. In case a borrower defaults, LACERA liquidates the collateral and purchases the securities on loan in the open market. Third, as a last resort, if there are insufficient funds from the collateral sale, LACERA receives indemnities from the lending agents for the full replacement of the securities on loan. Borrower defaults on securities loans are rare. LACERA has not been susceptible to losses from borrower defaults since the program's inception.

COLLATERAL REINVESTMENT RISK

Another risk is that SSgA invests the cash collateral, but LACERA bears 100% of the reinvestment risk under the terms of the agreement. Because LACERA invests the cash in money market funds and structured products, the collateral is exposed to credit and interest rate risk. Credit risk is the risk that an investment drops in value because of a credit quality downgrade or bond issuer default. Interest rate risk is the risk that an investment return will be less than the rebates paid to borrowers. LACERA has adopted conservative reinvestment guidelines as a control measure to mitigate these risks. Overall, LACERA's collateral reinvestment portfolio is designed to be diversified in liquid, high credit quality, short-term fixed income securities.

OPERATIONAL RISK

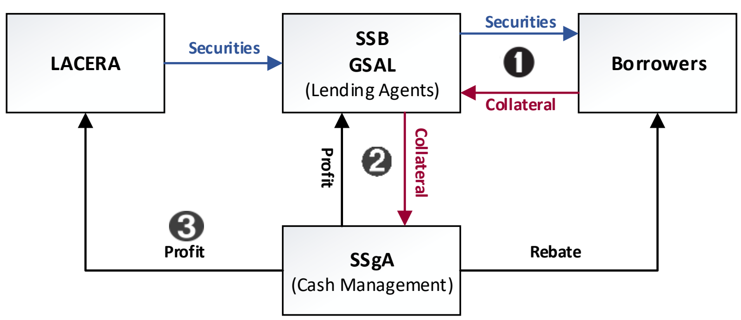
The last risk LACERA considers is operational risk, or the risk that a transaction does not work as planned because of human or system errors. Because securities lending is operationally intensive, this risk is mitigated by investing in automated systems and having staff routinely monitor borrower loan levels, mark-to-market activities, and investment guideline compliance.

AUDIT OBJECTIVES

Our audit objectives were to assess whether SSB and GSAL, the lending agents, are in compliance with key provisions of the SLAAs as noted below. Specifically, we verified the following:

(1) **LENDING TRANSACTIONS:** SSB and GSAL lend to only approved borrowers and fully collateralize each loan according to the SLAAs.
(2) **CASH COLLATERAL REINVESTMENT:** SSgA reinvests the cash collateral according to the investment guidelines outlined in the SLAA.
(3) **INCOME & FEES:** Income splits and fees are calculated correctly and charged to LACERA according to the SLAAs.

In addition, we assessed the reasonableness of LACERA and the lending agents' operational controls when administering the program. The diagram below illustrates the areas reviewed as part of this audit.



AUDIT SCOPE

The audit scope covered:

(1) Specific provisions within the 2013 LACERA-SSB SLAA and 2010 LACERA-GSAL SLAA.
(2) Procedures on the daily collateral reconciliations.
(3) Discussions with Investments Office around management of the program.
(4) Onsite meetings with lending agents as it relates to:
   - Front office review with traders[(1)]

- Middle office review with IT and risk management
- Back office review with operations, legal, and compliance

(5) Demonstrations of the securities lending online compliance reporting systems.
(6) Controls and transactions testing[(2)] to ensure operations are performed according to established procedures.

Notes:
[(1)] Internal Audit did not observe live trades between traders and borrowers, or review the database management systems for pricing securities at the lending agencies.

[(2)] The review period covered LACERA's fiscal year 2017. Internal Audit reviewed the daily compliance reports for the month of June 2017, and the daily compliance reports for the last day of each month-end for fiscal year 2017.

AUDIT METHODOLOGY

(1) To test for compliance with SLAA provisions as it relates to lending transactions:
- Compared the SLAA list of approved borrowers to borrowers named in the daily investment activities. This control test offered visibility into the borrowers as well as LACERA's exposure levels at each of the lending agencies.
- Examined LACERA's loan exposure for each counterparty relative to the entire loan amount. The concentration levels were calculated for each borrower on the last day of each month-end for fiscal year 2017.
- Determined whether lending agents mark-to-market securities at the minimum protective levels based on the market value of the securities on loan. This control test was to verify that loans are fully collateralized at 102% and 105% for domestic and international securities, respectively.

(2) To test for compliance with SLAA provisions as it relates to cash collateral reinvestment:
- Determined concentration levels for each asset class and compared levels to SLAA guidelines.
- Verified weighted average maturities ("WAM") and weighted average lives ("WAL") of securities in the collateral funds for compliance with SLAA guidelines.
- Identified the asset class and credit quality of each investment for compliance with SLAA guidelines. SSB has 754 securities and GSAL has 974 securities.

(3) To test for compliance with SLAA provisions as it relates to income and fees:
- Reconciled daily loan balances in June 2017 (8,957 SSB and 17,350 GSAL records) to the monthly totals.
- Recalculated daily and monthly investment earnings at each lending agency.
- Determined accuracy of the income splits between LACERA and lending agents.
- Identified investment trends from cash and non-cash collateral received.
- Reviewed monthly invoices billed to LACERA for third-party lending services.

(4) To assess the reasonableness of the operational controls in administering the program:
- Performed onsite review of SSB and GSAL offices to understand their operational controls.
- Interviewed Investments Office staff responsible for oversight of the securities lending program.

AUDIT RESULTS

Overall, Internal Audit found the lending agents to have adequate controls and procedures for the three compliance areas reviewed. The table below summarizes Internal Audit's assessment of ten SLAA provisions reviewed within LACERA's securities lending program.

Table A: SLAA Provisions Reviewed

				Compliance Assessment	
Area Reviewed	**Metric**	**Metric Description**	**Reason**	**State Street Bank**	**Goldman Sachs**
Lending Transactions	Approved borrowers	Verified securities are loaned to borrowers who have been approved by LACERA.	Borrower default risk	✓	✓
	Borrower exposure	Determine market value and proportionate share of securities on loan with each borrower.	Borrower default risk	Not applicable (no provision exists)	✓
	Loan collateralization levels	Verified market value of collateral falls within market value of securities on loan at protective levels (102%/105%).	Market and liquidity risks	✓	✓
Cash Collateral Reinvestment	Asset type	Determined proportionate share of securities by asset class.	Risk profile	✓	Not applicable
	Credit quality	Verified credit rating for each security at time of purchase.	Credit risk	✓	Not applicable
	Weighted Average Maturity Weighted Average Life (WAM) / (WAL)	Calculated weighted average number of days to final payment and interest reset date for each security.	Interest rate risk	✓	Not applicable
Income and Fees	Earnings	Calculated earnings for each account and security.	Operational risk	✓	✓
	Securities trading special	Identified securities with high borrowing demand, noted by high fees paid by the borrower.	Risk profile	✓	✓
	Trends	Tracked cash and non-cash collateral received over time.	Risk profile	✓	✓
	Third-party flat fees	Analyzed flat fees charged to LACERA for security and wire transfers exchanged between SSB and GSAL.	Operational risk	✓	✓

Internal Audit observed the following good practices with administering the program:

- Lending agents have loan balances concentrated with high-quality borrowers.
- Lending agents provide indemnifications against borrower default.
- Segregation of duties exist between traders and the delivery of loaned securities.
- Lending agents have automated validation systems to ensure compliance with collateral guidelines.
- Cash management interacts with portfolio managers to confirm daily cash flows from lending activity.
- Lending agents and LACERA discuss investment strategies and performance regularly.
- Investment earnings are paid timely and accurately to LACERA.
- Lending agents have good security controls for their online reporting systems.

While we observed good practices at SSB, GSAL, and LACERA, we identified two opportunities for management to further strengthen their processes. Our observations and recommendations are detailed below.

Review SLAA Provisions on Non-Cash Collateral
A good practice is to periodically review and amend the SLAA guidelines to reflect the current market environment. Because of recent regulations around Dodd Frank and Basel III, we have seen a steady rise in the amount of non-cash collateral pledged. For fiscal year 2017, we have seen SSB accept 45% cash and 55% non-cash collateral from borrowers. Historically, the ratios have been skewed towards cash collateral. It would be prudent for management to revisit the LACERA-SSB SLAA and evaluate the impact of accepting cash and non-cash securities, because the non-cash collateral can alter the risk-return profile of the program. For example, we noted that 45% of cash collateral generated 60% of LACERA's earnings, and 55% of non-cash collateral generated 40% of LACERA's earnings. Management should be aware of the collateral risks, and ensure that there are adequate protections in the SLAA.

RECOMMENDATION

1. **Investments Office to review the SLAA provisions and make necessary adjustments to non-cash collateral.**

Management Response
Investment office agrees that it is good practice to periodically review the SLAA—and amend it when appropriate—to ensure that the SLAA provisions remain consistent with market conditions. We are finalizing our annual report on the securities lending program, and that report will be an "information only" item on the June BOI calendar. As part of that report, we will review the SLAA. If any adjustments are needed for non-cash collateral, we will implement them during the first quarter of fiscal year 2018/2019.

Assess Fee Implications of Using Third-Party Agents

In an April 2017 memorandum to the Board of Investments, management expressed the need to periodically rebid the securities lending program as a good measure. Should this be done in the near future, it is good practice to understand the fee implications of using third-party lending agents and the impact on program cost and performance.

During our review, we observed two cases when LACERA incurred additional costs for using GSAL as a third-party lending agent. The first case involves cash management, and the amount SSgA billed LACERA to manage the two cash collateral funds. Currently, LACERA pays SSgA 5 basis points for the GSAL fund and 1 basis point for the SSB fund. Depending on the cash collateral funds' balances, a 4 basis points differential can mean several hundred thousand dollars for LACERA annually. The second case involves SSB (as LACERA's custodian bank) billing LACERA for handling security and wire transfers associated with GSAL's third-party lending program. For GSAL's program, the cost to LACERA was $200,000, the annual fee maximum negotiated in the LACERA-SSB agreement. In contrast, SSB waives security and wire transfer fees for handling SSB's lending program.

Even though LACERA incurred additional costs for using GSAL as a third-party lending agent, it would be difficult to quantify or contend that LACERA is better off using a single lender over multiple third-party lenders. First of all, SSB and GSAL lend different security types for LACERA, so a true cost comparison could not be performed. Second of all, some of SSB's fees for custody banking, securities lending, and cash management are bundled together, so it would be difficult to measure the true cost of SSB's securities lending program on its own. LACERA may benefit from unbundling each SSB service offering and pricing it individually. In doing so, management can understand the costs-benefits of using third-party agents, and determine the best course of action for LACERA and the program going forward.

RECOMMENDATION

2. **Investments Office to assess the fee implications of working with third-party agents for securities lending.**

Management Response
Subject to BOI approval, Staff anticipates issuing an RFP for securities lending services in fiscal year 2018/2019, and that search will include an assessment of all related fees, including for third-party agents.

We thank the Investments Office, State Street Bank, and Goldman Sachs Agency Lending for their assistance and cooperation with this audit.

NOTED AND APPROVED

Leisha Collins on behalf of: **Date:** August 31, 2018
Richard Bendall
Chief Audit Executive

REPORT DISTRIBUTION

2018 Audit Committee	*Robert Hill*	*Jon Grabel*
Rick Wentzel	*James Brekk*	*Vache Mahseredjian*
Internal Audit Staff	*Bernie Buenaflor*	*Steven Rice*
	JJ Popowich	*Christine Roseland*

LACERA INTERNAL AUDIT DIVISION

Securities Lending Program

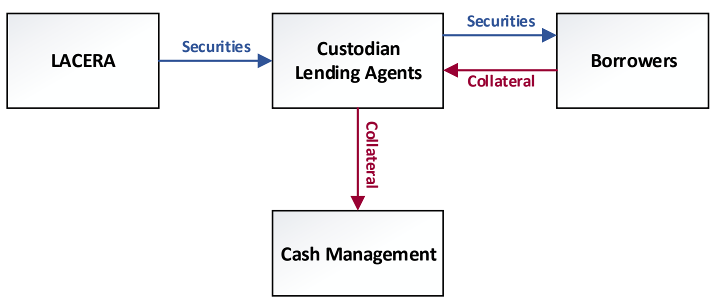
Version with Audit Committee Comments & Internal Audit Responses

May 30, 2018

AUDIT PERFORMED BY:
Kathryn Ton, CPA, CFE
Senior Internal Auditor

EXECUTIVE SUMMARY

We reviewed LACERA's securities lending program as part of the fiscal year 2018 audit plan. LACERA's Investments Office is responsible for the proper management and monitoring of the securities lending program. State Street Bank and Goldman Sachs are lending agents to the program, and make investment decisions on LACERA's behalf. LACERA's earnings from the securities lending program are used to fund the benefits of 165,000 LACERA members.
AC QUESTION: What is the "benefit" I receive as a current employee?
IA RESPONSE: The incremental income from the securities lending program contributes toward funding the defined benefit pension plan for vested LACERA employees at the time of retirement.
The purpose of this audit is to assess whether LACERA and the lending agents are in compliance with key provisions of the Securities Lending Agency Agreements ("SLAA"), as noted in the audit objectives on page 6 and Table A on page 8 of the report. The diagram below illustrates the process flows between the parties involved when administering the program.



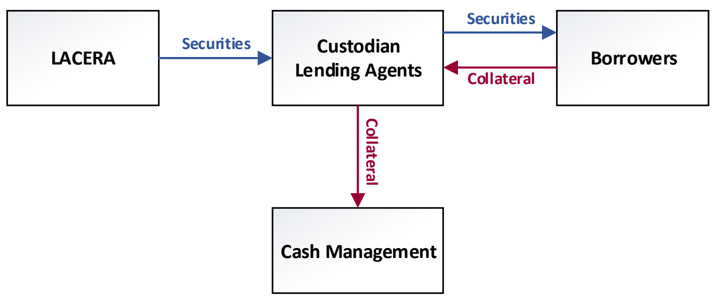
The securities lending program is intended to generate incremental returns to offset administrative expenses at a manageable level of risk. For fiscal year 2017, LACERA had an investment portfolio of $14.2 billion in lendable securities, $1.4 billion of which were loaned to qualified borrowers. At a 10% utilization rate, one-tenth of LACERA's fixed income and public equities portfolio were out on loan. LACERA generated $6.8 million from the program, net of fees.

Based on our review, Internal Audit found the lending agents to be in compliance with the key SLAA provisions reviewed, and the related controls to be effective and functioning as intended. Specifically, we noted that the lending agents have adequate controls to loan securities to approved borrowers in the SLAA. In addition, there are automated systems and management oversight to ensure that the loans are collateralized at or above the contractual requirements. Moreover, the cash collateral was tested against the investment guidelines, and we did not note any exceptions. Lastly, we noted good controls in the income splits between LACERA and the lending agents to ensure compliance with the terms in the SLAA. We made two recommendations to the Investments Office for strengthening their oversight over the Program: (1) review and update the SLAA, and (2) assess the lending agents' service fees. The details of our observations and recommendations are addressed in the report. We thank the Investments Office, State Street Bank, and Goldman Sachs for their assistance and cooperation with this audit.

SECURITIES LENDING PROGRAM

INTRODUCTION

We reviewed LACERA's securities lending program as part of the fiscal year 2018 audit plan. LACERA's Investments Office is responsible for the proper management and monitoring of the securities lending program. State Street Bank and Goldman Sachs are lending agents to the program, and make investment decisions on LACERA's behalf. LACERA's earnings from the securities lending program are used to fund the benefits of 165,000 LACERA members. The purpose of this audit is to assess whether LACERA and the lending agents are in compliance with key provisions of the Securities Lending Agency Agreements ("SLAA"), as noted in the audit objectives on page 6 and Table A on page 8 of the report. The diagram below illustrates the process flows between the parties involved when administering the program.



The securities lending program is intended to generate incremental returns to offset administrative expenses at a manageable level of risk. For fiscal year 2017, LACERA had an investment portfolio of $14.2 billion in lendable securities, $1.4 billion of which were loaned to qualified borrowers. At a 10% utilization rate, one-tenth of LACERA's fixed income and public equities portfolio were out on loan. LACERA generated $6.8 million from the program, net of fees.

AC QUESTION: Is this figure cumulative, regardless of duration of loan? If so, the 10% utilization rate seems low, no?

IA RESPONSE: Correct, this figure is cumulative regardless of duration of loan. Collectively, SSB and GSAL lent $1.4 billion of $14.2 billion securities (10%) for LACERA in FY 2017. Historically, LACERA's utilization rate has been in the low to mid-teens over the past five years.

BACKGROUND

LACERA has been administering the securities lending program under the direction of the Board of Investments. Since the program has been established, LACERA has delegated responsibilities to lending agents that specialize in securities lending services. LACERA's securities lending program is managed by its custodian bank, State Street Bank and Trust Company ("SSB"), and a third-party lending agent, Goldman Sachs Agency Lending ("GSAL"). SSB's investment management team, State Street Global Advisors ("SSgA"), invests the cash collateral received from both lending programs. The table below summarizes LACERA's securities lending program structure.

Securities Lending Program Structure			
Lending Agent	Cash Management	Collateral Accepted	Securities Type
SSB	SSgA	Cash and non-cash	International Equities US Treasuries and US Agencies
GSAL	SSgA	Cash only	Domestic Equities Corporate Bonds

In securities lending, LACERA will loan securities to borrowers in exchange for collateral. Collateral can be in the form of cash or non-cash securities, and is at least 102% of the market value of the securities on loan. Income from securities lending is generated through (1) non-cash collateral fees and (2) cash collateral reinvestment. LACERA charges borrowers a fee for the non-cash collateral received as payment for the loan. Conversely, LACERA pays borrowers interest for the cash collateral received. However, the cash collateral is reinvested in short-term investments to generate a higher return than the interest paid to borrowers. When borrowers terminate the loan and return the securities, LACERA returns the collateral with interest – this is known as the rebate. Earnings in excess of the rebate are divided between LACERA and the lending agents on a pre-determined basis, based on the income splits negotiated in the SLAA.

Investment Earnings		
Lending Agent	LACERA Split	Lending Agent Split
SSB	85%	15%
GSAL	87%	13%

SECURITIES LENDING PROGRAM RISKS

While securities lending is generally a low-risk investment program, there are three main risks associated with securities lending: (1) borrower default risk, (2) collateral reinvestment risk and (3) operational risk. We discuss each risk below and the mitigating controls necessary to administer an effective securities lending program.

BORROWER DEFAULT RISK

One risk that LACERA considers is the credit or borrower risk – namely, the risk that borrowers will go bankrupt and not return the securities on loan. LACERA and the lending agents have a three-step approach to mitigate this risk. First, lending agents must undertake a formal process for evaluating the credit of each borrower before and after including them on the approved borrowers list. Second, LACERA requires borrowers to pledge collateral over and above the value of the lent securities to absorb potential losses. In case a borrower defaults, LACERA liquidates the collateral and purchases the securities on loan in the open market. Third, as a last resort, if there are insufficient funds from the collateral sale, LACERA receives indemnities from the lending agents for the full replacement of the securities on loan. Borrower defaults on securities loans are rare. LACERA has not been susceptible to losses from borrower defaults since the program's inception.

AC QUESTION: Have there been any losses in the program from other than borrower defaults, and if so, from what source?

IA RESPONSE: The securities lending program has generated a net profit every year. However, there was a loss in 2008 as a result of a defaulted security in the collateral pool managed by LACERA's former custodian (BNY Mellon). This loss amounted to $872K. Staff provided two memos to the Board of Investments on this loss.

COLLATERAL REINVESTMENT RISK
Another risk is that SSgA invests the cash collateral, but LACERA bears 100% of the reinvestment risk under the terms of the agreement. Because LACERA invests the cash in money market funds and structured products, the collateral is exposed to credit and interest rate risk. Credit risk is the risk that an investment drops in value because of a credit quality downgrade or bond issuer default. Interest rate risk is the risk that an investment return will be less than the rebates paid to borrowers. LACERA has adopted conservative reinvestment guidelines as a control measure to mitigate these risks. Overall, LACERA's collateral reinvestment portfolio is designed to be diversified in liquid, high credit quality, short-term fixed income securities.
AC QUESTION: The prior sentence states SSgA invests the collateral. This sentence states that LACERA invests it.
IA RESPONSE: In this context we meant SSgA invests on LACERA's behalf.

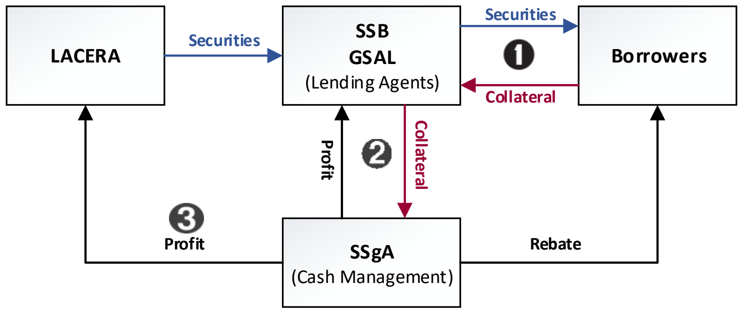
OPERATIONAL RISK
The last risk LACERA considers is operational risk, or the risk that a transaction does not work as planned because of human or system errors. Because securities lending is operationally intensive, this risk is mitigated by investing in automated systems and having staff routinely monitor borrower loan levels, mark-to-market activities, and investment guideline compliance.
AC QUESTION: What does "operationally intensive" mean?
IA RESPONSE: Many operations in securities lending involve manual processes that have been mitigated by investing in automated systems. For example, SSB and GSAL have automated securities loan and return processing and the process for negotiating certain types of trades.

AUDIT OBJECTIVES

Our audit objectives were to assess whether SSB and GSAL, the lending agents, are in compliance with key provisions of the SLAAs as noted below. Specifically, we verified the following:

(1) **LENDING TRANSACTIONS:** SSB and GSAL lend to only approved borrowers and fully collateralize each loan according to the SLAAs.
(2) **CASH COLLATERAL REINVESTMENT:** SSgA reinvests the cash collateral according to the investment guidelines outlined in the SLAA.
(3) **INCOME & FEES:** Income splits and fees are calculated correctly and charged to LACERA according to the SLAAs.

In addition, we assessed the reasonableness of LACERA and the lending agents' operational controls when administering the program. The diagram below illustrates the areas reviewed as part of this audit.



AUDIT SCOPE

The audit scope covered:

(1) Specific provisions within the 2013 LACERA-SSB SLAA and 2010 LACERA-GSAL SLAA.
AC QUESTION: Are these applicable in 2018?
IA RESPONSE: The SLAAs are evergreen contracts and applicable in 2018.
(2) Procedures on the daily collateral reconciliations.
(3) Discussions with Investments Office around management of the program.
(4) Onsite meetings with lending agents as it relates to:
- Front office review with traders(1)
- Middle office review with IT and risk management
- Back office review with operations, legal, and compliance

(5) Demonstrations of the securities lending online compliance reporting systems.
(6) Controls and transactions testing(2) to ensure operations are performed according to established procedures.

Notes:
(1) Internal Audit did not observe live trades between traders and borrowers, or review the database management systems for pricing securities at the lending agencies.

(2) The review period covered LACERA's fiscal year 2017. Internal Audit reviewed the daily compliance reports for the month of June 2017, and the daily compliance reports for the last day of each month-end for fiscal year 2017.

AUDIT METHODOLOGY

(1) To test for compliance with SLAA provisions as it relates to lending transactions:
- Compared the SLAA list of approved borrowers to borrowers named in the daily investment activities. This control test offered visibility into the borrowers as well as LACERA's exposure levels at each of the lending agencies.

- Examined LACERA's loan exposure for each counterparty relative to the entire loan amount. The concentration levels were calculated for each borrower on the last day of each month-end for fiscal year 2017.
- Determined whether lending agents mark-to-market securities at the minimum protective levels based on the market value of the securities on loan. This control test was to verify that loans are fully collateralized at 102% and 105% for domestic and international securities, respectively.

(2) To test for compliance with SLAA provisions as it relates to cash collateral reinvestment:
- Determined concentration levels for each asset class and compared levels to SLAA guidelines.
- Verified weighted average maturities ("WAM") and weighted average lives ("WAL") of securities in the collateral funds for compliance with SLAA guidelines.
- Identified the asset class and credit quality of each investment for compliance with SLAA guidelines. SSB has 754 securities and GSAL has 974 securities.

(3) To test for compliance with SLAA provisions as it relates to income and fees:
- Reconciled daily loan balances in June 2017 (8,957 SSB and 17,350 GSAL records) to the monthly totals.
- Recalculated daily and monthly investment earnings at each lending agency.
- Determined accuracy of the income splits between LACERA and lending agents.
- Identified investment trends from cash and non-cash collateral received.
- Reviewed monthly invoices billed to LACERA for third-party lending services.

(4) To assess the reasonableness of the operational controls in administering the program:
- Performed onsite review of SSB and GSAL offices to understand their operational controls.
- Interviewed Investments Office staff responsible for oversight of the securities lending program.

AUDIT RESULTS

Overall, Internal Audit found the lending agents to have adequate controls and procedures for the three compliance areas reviewed. The table below summarizes Internal Audit's assessment of ten SLAA provisions reviewed within LACERA's securities lending program.

AC QUESTION: The Compliance Assessment below suggests that the contractual provisions of the two contracts differ. Why is that?

IA RESPONSE: The contractual provisions are different because GSAL does not offer collateral investment management services. SSB's SSgA performs the investment management service for the GSAL cash collateral pool. In addition, the agreements were executed in different years and involve different security types.

Table A: SLAA Provisions Reviewed

Area Reviewed	Metric	Metric Description	Reason	Compliance Assessment	
				State Street Bank	Goldman Sachs
Lending Transactions	Approved borrowers	Verified securities are loaned to borrowers who have been approved by LACERA.	Borrower default risk	✓	✓
	Borrower exposure	Determine market value and proportionate share of securities on loan with each borrower.	Borrower default risk	Not applicable (no provision exists)	✓
	Loan collateralization levels	Verified market value of collateral falls within market value of securities on loan at protective levels (102%/105%).	Market and liquidity risks	✓	✓
Cash Collateral Reinvestment	Asset type	Determined proportionate share of securities by asset class.	Risk profile	✓	Not applicable
	Credit quality	Verified credit rating for each security at time of purchase.	Credit risk	✓	Not applicable
	Weighted Average Maturity Weighted Average Life (WAM) / (WAL)	Calculated weighted average number of days to final payment and interest reset date for each security.	Interest rate risk	✓	Not applicable
Income and Fees	Earnings	Calculated earnings for each account and security.	Operational risk	✓	✓
	Securities trading special	Identified securities with high borrowing demand, noted by high fees paid by the borrower.	Risk profile	✓	✓
	Trends	Tracked cash and non-cash collateral received over time.	Risk profile	✓	✓
	Third-party flat fees	Analyzed flat fees charged to LACERA for security and wire transfers exchanged between SSB and GSAL.	Operational risk	✓	✓

Internal Audit observed the following good practices with administering the program:

- Lending agents have loan balances concentrated with high-quality borrowers.
- Lending agents provide indemnifications against borrower default.
- Segregation of duties exist between traders and the delivery of loaned securities.
- Lending agents have automated validation systems to ensure compliance with collateral guidelines.
- Cash management interacts with portfolio managers to confirm daily cash flows from lending activity.
- Lending agents and LACERA discuss investment strategies and performance regularly.
- Investment earnings are paid timely and accurately to LACERA.
- Lending agents have good security controls for their online reporting systems.

While we observed good practices at SSB, GSAL, and LACERA, we identified two opportunities for management to further strengthen their processes. Our observations and recommendations are detailed below.

Review SLAA Provisions on Non-Cash Collateral

A good practice is to periodically review and amend the SLAA guidelines to reflect the current market environment. Because of recent regulations around Dodd Frank and Basel III, we have seen a steady rise in the amount of non-cash collateral pledged. For fiscal year 2017, we have seen SSB accept 45% cash and 55% non-cash collateral from borrowers. Historically, the ratios have been skewed towards cash collateral. It would be prudent for management to revisit the LACERA-SSB SLAA and evaluate the impact of accepting cash and non-cash securities, because the non-cash collateral can alter the risk-return profile of the program. For example, we noted that 45% of cash collateral generated 60% of LACERA's earnings, and 55% of non-cash collateral generated 40% of LACERA's earnings. Management should be aware of the collateral risks, and ensure that there are adequate protections in the SLAA.

AC QUESTION: For how long has each Agreement been in place? In lieu of revising agreement components to reflect then current market conditions, another option could be to re-solicit the business in its entirety, no?

IA RESPONSE: The agreements have been in place with SSB for 5 years and GSAL for 8 years. Correct, LACERA has the option to re-solicit the securities lending program in its entirety. Investments Office management has indicated in their response that they will be issuing an RFP for securities lending services in fiscal year 2018/2019.

<u>RECOMMENDATION</u>

1. **Investments Office to review the SLAA provisions and make necessary adjustments to non-cash collateral.**

<u>Management Response</u>

Investment office agrees that it is good practice to periodically review the SLAA—and amend it when appropriate—to ensure that the SLAA provisions remain consistent with market conditions. We are finalizing our annual report on the securities lending program, and that report will be an "information only" item on the June BOI calendar. As part of that report, we will review the SLAA. If any adjustments are needed for non-cash collateral, we will implement them during the first quarter of fiscal year 2018/2019.

Assess Fee Implications of Using Third-Party Agents

AC QUESTION: What I didn't see is an assessment of unbundling the securities lending program from the custodian. Unless you unbundle it from the custodian, you don't know if in fact your custodian is the best deal.

IA RESPONSE: Investments Office management will assess the feasibility of determining the costs of each SSB service as if they were unbundled during the next securities lending solicitation process.

In an April 2017 memorandum to the Board of Investments, management expressed the need to periodically rebid the securities lending program as a good measure. Should this be done in the near future, it is good practice to understand the fee implications of using third-party lending agents and the impact on program cost and performance.

AC QUESTION: I agree, but it is also reasonable to understand the role of the third-party lending agent. The fee may be prudent for its role.

IA RESPONSE: We agree. The role of a third-party lending agent should also be considered.

During our review, we observed two cases when LACERA incurred additional costs for using GSAL as a third-party lending agent. The first case involves cash management, and the amount SSgA billed LACERA to manage the two cash collateral funds. Currently, LACERA pays SSgA 5 basis points for the GSAL fund and 1 basis point for the SSB fund. Depending on the cash collateral funds' balances, a 4 basis points differential can mean several hundred thousand dollars for LACERA annually. The second case involves SSB (as LACERA's custodian bank) billing LACERA for handling security and wire transfers associated with GSAL's third-party lending program. For GSAL's program, the cost to LACERA was $200,000, the annual fee maximum negotiated in the LACERA-SSB agreement. In contrast, SSB waives security and wire transfer fees for handling SSB's lending program.

Even though LACERA incurred additional costs for using GSAL as a third-party lending agent, it would be difficult to quantify or contend that LACERA is better off using a single lender over multiple third-party lenders. First of all, SSB and GSAL lend different security types for LACERA, so a true cost comparison could not be performed. Second of all, some of SSB's fees for custody banking, securities lending, and cash management are bundled together, so it would be difficult to measure the true cost of SSB's securities lending program on its own. LACERA may benefit from unbundling each SSB service offering and pricing it individually. In doing so, management can understand the costs-benefits of using third-party agents, and determine the best course of action for LACERA and the program going forward.

RECOMMENDATION

2. **Investments Office to assess the fee implications of working with third-party agents for securities lending.**

Management Response
Subject to BOI approval, Staff anticipates issuing an RFP for securities lending services in fiscal year 2018/2019, and that search will include an assessment of all related fees, including for third-party agents.

We thank the Investments Office, State Street Bank, and Goldman Sachs Agency Lending for their assistance and cooperation with this audit.

NOTED AND APPROVED

Leisha Collins on behalf of:
Richard Bendall
Chief Audit Executive

Date: August 31, 2018

REPORT DISTRIBUTION

2018 Audit Committee	*Robert Hill*	*Jon Grabel*
Rick Wentzel	*James Brekk*	*Vache Mahseredjian*
Internal Audit Staff	*Bernie Buenaflor*	*Steven Rice*
	JJ Popowich	*Christine Roseland*

LACERA

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Leisha Collins
Principal Internal Auditor

FOR**:** September 12, 2018 Audit Committee Meeting

SUBJECT: **Tier 2 Retiree Healthcare Benefits Program**

RECOMMENDATION

In accordance with your current Audit Committee Charter, staff recommends that the Audit Committee review and discuss the following engagement report to take the following action(s):

1. **accept and file report and/or,**
2. **instruct staff to forward report to Boards or Committees and/or,**
3. **provide further instruction to staff.**

ENGAGEMENT REPORTS

a. Tier 2 Retiree Healthcare Benefits Program
Nathan Amick, Internal Auditor
(Report issued: June 19, 2018)

Please note: attached to the report is another version of the report that includes questions and comments that staff received from your Committee as well as Internal Audit's responses.

Attachments

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Nathan Amick
Internal Auditor

FOR**:** September 12, 2018 Audit Committee Meeting

SUBJECT: **Tier 2 Retiree Healthcare Benefits Program**

EXECUTIVE SUMMARY

As part of the fiscal year 2018 Audit Plan, Internal Audit staff reviewed LACERA's process for identifying retirees who should be enrolled in the new Tier 2 Retiree Healthcare Benefits Program (Tier 2). Based on our review and testing of Retiree Healthcare ("RHC") Division's related internal controls, we found that RHC management has a well-established process for identifying Tier 2 participants to ensure that those retirees are enrolled in the correct Tier 2 program.

BACKGROUND

On June 17, 2014, the Board of Supervisors approved a recommendation issued from the County's Chief Executive Officer to change the Retiree Healthcare Benefits Program by adding a new tier, Tier 2. Due to the rising costs of medical benefits, it became apparent to both the County and LACERA that the previous Retiree Healthcare Benefits Program structure ("Tier 1") would become financially unstable in the future. In an effort to reduce the County's unfunded OPEB liability and ensure the longevity and perpetuity of the Retiree Healthcare Benefits Program, the County, along with LACERA and SEIU representatives, worked together to change the Retiree Healthcare Benefits Program by adding a second tier of benefits for employees hired after June 30, 2014.

With the rising costs of medical benefits being the primary concern for the County, Tier 2 participants will not receive subsidized healthcare for spouses or dependents, unlike Tier 1. In addition, Tier 2 participants must enroll in a Medicare subsidized plan at age 65, while Tier 1 participants are not required to participate in such plans. Consequently, it is imperative for RHC Division staff to determine what healthcare program the retiree should be enrolled in.

Like Tier 1 participants, Tier 2 participants must have at least 10 years of service credit to be eligible for a medical subsidy. Tier 2 members without 10 years of service, along with their spouses and dependents, can participate in the Tier 2 Program but will not be eligible for a subsidy. As a result, Tier 2 members will not begin receiving their medical subsidies until July 1, 2024, with possible exceptions for service-connected disability retirees.

AUDIT PROCESS

As part of the audit, we reviewed the identification process of retirees who should be enrolled in Tier 2. Our objective was to assess the effectiveness of RHC's internal controls in the identification process mentioned above. To attain our objective, we interviewed RHC and Systems Division management and staff, and reviewed relevant Tier 2 reports, memos, and enrollment checklists.

AUDIT RESULTS

As a result of our interviews and review process, we determined that management has adequate controls for ensuring that County employees hired after June 1, 2014 are correctly enrolled in the Tier 2 Program. Specifically, management has two key controls for identifying retirees who should be enrolled in the Tier 2.

1.) A "Potential Tier 2 Members Report" is generated monthly by the Systems Division, and identifies newly retired members meeting Tier 2 eligibility requirements. We met with Systems Division staff and reviewed the query used to generate the "Potential Tier 2 Members Report". Based our review, the query correctly identifies retirees meeting Tier 2 eligibility requirements. We also tested RHC's review of the "Potential Tier 2 Members Report", and verified that RHC staff reviews the report and correctly labels the member's Workspace account when members meet Tier 2 eligibility.

2.) An "Enrollment Form Processing Checklist" is prepared by RHC staff for each new retiree enrolling in a healthcare benefits program. The checklist requires that RHC staff document the retirees hire date and "reciprocal status" to assess whether the retiree is eligible for the Tier 1 or Tier 2. LACERA members hired after June 30, 2014 could still qualify as Tier 1 members if they were members of another public retirement system prior to June 30, 2014 that has reciprocal status with LACERA. After the "Enrollment Form Processing Checklist" is completed, two additional RHC staff review the checklist for completeness and accuracy. We randomly selected 10 retiree healthcare enrollees and verified that a checklist was completed and reviewed by two additional RHC staff.

CONCLUSION

As required by the County, LACERA must enroll all new members hired after June 30, 2014 in the new Tier 2 Retiree Healthcare Benefits Program. Based on our review and testing of Retiree Healthcare Davison's related internal controls, we found that LACERA has a well-established process for identifying Tier 2 participants to ensure that those participants are correctly enrolled in the Tier 2 program.

NOTED AND APPROVED

Leisha Collins, Principal Internal Auditor, on behalf of: **Date:** August 31, 2018
Richard Bendall
Chief Audit Executive

CC:

2018 Audit Committee	*Robert Hill*	*Bernie Buenaflor*
Rick Wentzel	*James Brekk*	*Steven Rice*
Internal Audit Staff	*JJ Popowich*	*Cassandra Smith*
		Mary Phillips

Version with Audit Committee Comments & Internal Audit Responses

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Nathan Amick
Internal Auditor

FOR**:** September 12, 2018 Audit Committee Meeting

SUBJECT: **Tier 2 Retiree Healthcare Benefits Program**

EXECUTIVE SUMMARY

As part of the fiscal year 2018 Audit Plan, Internal Audit staff reviewed LACERA's process for identifying retirees who should be enrolled in the new Tier 2 Retiree Healthcare Benefits Program (Tier 2). Based on our review and testing of Retiree Healthcare ("RHC") Division's related internal controls, we found that RHC management has a well-established process for identifying Tier 2 participants to ensure that those retirees are enrolled in the correct Tier 2 program.

BACKGROUND

On June 17, 2014, the Board of Supervisors approved a recommendation issued from the County's Chief Executive Officer to change the Retiree Healthcare Benefits Program by adding a new tier, Tier 2. Due to the rising costs of medical benefits, it became apparent to both the County and LACERA that the previous Retiree Healthcare Benefits Program structure ("Tier 1") would become financially unstable in the future. In an effort to reduce the County's unfunded OPEB liability and ensure the longevity and perpetuity of the Retiree Healthcare Benefits Program, the County, along with LACERA and SEIU representatives, worked together to change the Retiree Healthcare Benefits Program by adding a second tier of benefits for employees hired after June 30, 2014.

With the rising costs of medical benefits being the primary concern for the County, Tier 2 participants will not receive subsidized healthcare for spouses or dependents, unlike Tier 1. In addition, Tier 2 participants must enroll in a Medicare subsidized plan at age 65, while Tier 1 participants are not required to participate in such plans. Consequently, it is imperative for RHC Division staff to determine what healthcare program the retiree should be enrolled in.

Like Tier 1 participants, Tier 2 participants must have at least 10 years of service credit to be eligible for a medical subsidy. Tier 2 members without 10 years of service, along with their spouses and dependents, can participate in the Tier 2 Program but will not be eligible for a subsidy. As a result, Tier 2 members will not begin receiving their medical subsidies until July 1, 2024, with possible exceptions for service-connected disability retirees.

AUDIT PROCESS

As part of the audit, we reviewed the identification process of retirees who should be enrolled in Tier 2. Our objective was to assess the effectiveness of RHC's internal controls in the identification process mentioned above. To attain our objective, we interviewed RHC and Systems Division management and staff, and reviewed relevant Tier 2 reports, memos, and enrollment checklists.

AUDIT RESULTS

As a result of our interviews and review process, we determined that management has adequate controls for ensuring that County employees hired after June 1, 2014 are correctly enrolled in the Tier 2 Program. Specifically, management has two key controls for identifying retirees who should be enrolled in the Tier 2.

1.) A "Potential Tier 2 Members Report" is generated monthly by the Systems Division, and identifies newly retired members meeting Tier 2 eligibility requirements. We met with Systems Division staff and reviewed the query used to generate the "Potential Tier 2 Members Report". Based our review, the query correctly identifies retirees meeting Tier 2 eligibility requirements. We also tested RHC's review of the "Potential Tier 2 Members Report", and verified that RHC staff reviews the report and correctly labels the member's Workspace account when members meet Tier 2 eligibility.

AC Question: Two questions: 1) I found it interesting that you are not interested in the Tier classification until eligibility kicks in. Why is that? 2) Isn't it the hire date alone that triggers application of a Tier 2 classification, absent reciprocal issues? If so, why isn't the employee assigned a Tier 2 classification upon first entering LACERA's system, making the subsequent "labelling" of the account unnecessary unless there is a reciprocal issue?

IA Response: Since the retirement processing and healthcare enrollment of Tier 2 members are still relatively new and uncommon, the exception report and subsequent labeling serve as an additional control for RHC staff to ensure that Tier 2 retirees are enrolled in the correct plan. Correct, the membership date triggers the application of Tier 2 except for reciprocal issues. By August 2018, Workspace will be programmed so that a Tier 1 or Tier 2 label will automatically

appear on the interface of each member account. The classification will also account for reciprocal issues.

2.) An "Enrollment Form Processing Checklist" is prepared by RHC staff for each new retiree enrolling in a healthcare benefits program. The checklist requires that RHC staff document the retirees hire date and "reciprocal status" to assess whether the retiree is eligible for the Tier 1 or Tier 2. LACERA members hired after June 30, 2014 could still qualify as Tier 1 members if they were members of another public retirement system prior to June 30, 2014 that has reciprocal status with LACERA. After the "Enrollment Form Processing Checklist" is completed, two additional RHC staff review the checklist for completeness and accuracy. We randomly selected 10 retiree healthcare enrollees and verified that a checklist was completed and reviewed by two additional RHC staff.

AC Question: And did you agree with the determination staff made?
IA Response: Yes, we agreed with their determinations.

CONCLUSION

As required by the County, LACERA must enroll all new members hired after June 30, 2014 in the new Tier 2 Retiree Healthcare Benefits Program.
AC Question: At the time of hire or the time of eligibility?
IA Response: At the date of enrollment which occurs after retirement.
Based on our review and testing of Retiree Healthcare Davison's related internal controls, we found that LACERA has a well-established process for identifying Tier 2 participants to ensure that those participants are correctly enrolled in the Tier 2 program.

NOTED AND APPROVED

Leisha E. Collins

Leisha Collins, Principal Internal Auditor, on behalf of: **Date:** August 31, 2018
Richard Bendall
Chief Audit Executive

CC:

2018 Audit Committee	*Robert Hill*	*Bernie Buenaflor*
Rick Wentzel	*James Brekk*	*Steven Rice*
Internal Audit Staff	*JJ Popowich*	*Cassandra Smith*
		Mary Phillips

L//CERA

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Leisha Collins
Principal Internal Auditor

FOR**:** September 12, 2018 Audit Committee Meeting

SUBJECT: **Contract Monitoring Program Status Update**

RECOMMENDATION

In accordance with your current Audit Committee Charter, staff recommends that the Audit Committee review and discuss the following engagement report to take the following action(s):

1. **accept and file report and/or,**
2. **instruct staff to forward report to Boards or Committees and/or,**
3. **provide further instruction to staff.**

ENGAGEMENT REPORTS

a. Contract Monitoring Program Status Update
Kathryn Ton, Senior Internal Auditor
(Report issued: June 19, 2018)

Please note: attached to the report is another version of the report that includes questions and comments that staff received from your Committee as well as Internal Audit's responses.

Attachments

L///CERA

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Kathryn Ton, CPA, CFE KT
Senior Internal Auditor

FOR: September 12, 2018 Audit Committee Meeting

SUBJECT: **CONTRACT MONITORING PROGRAM STATUS UPDATE**

INTRODUCTION

Internal Audit reviewed LACERA's contract monitoring program as part of the fiscal year 2018 audit plan. This was in response to a prior audit finding in which LACERA continued doing business with a vendor who had an expired contract. Management addressed the internal audit finding in a January 2016 memo to the Operations Oversight Committee ("OOC"), and committed to building a robust contract monitoring process which would prevent such future occurrences. Management's contract monitoring process[1] would involve:

(1) Identifying and collecting LACERA contracts
(2) Developing a contract management system to store and monitor existing contracts.

Internal Audit met with management, and learned that the implementation of the contract monitoring program is still in-progress. Therefore, we performed a high-level review of the program at its current state. A more detailed audit will be performed once the program is fully implemented. The purpose of this memo is to update the Audit Committee on (1) management's existing plans and progress and (2) areas in need of management's attention while the rollout is underway.

BACKGROUND

Contract monitoring is an important area of compliance, because an effective contract monitoring program can help manage financial and operational risks when working with third-party vendors. Third-party vendors are contractually obligated to perform services within the agreed-upon terms, and LACERA is contractually obligated to remit payment for those services. The inability to do either is a financial and operational risk on LACERA, and opens the door for litigation and other regulatory issues. Management is mitigating

[1] (1) and (2) are focused on the compilation of contracts for all divisions except the Investments Office. The Investments Office, in conjunction with the Legal Office, maintain and manage investment related contracts. Investments Office staff monitor the contracts of their investment managers and investment related vendors.

those risks by building a contract management system to account for and monitor all existing contracts.

MANAGEMENT'S PLANS

Based on our review, management is headed in the right direction with the buildout of the contract management system ("CMS") application. Currently, the CMS acts as a repository for LACERA contracts and can accomplish items (1) and (2) above. Upon completion of the CMS, the system can then be beta tested and implemented. In addition, we observed that members from the Executive Office, Administrative Services Division, and Systems Division have developed instruction manuals, forms, and training materials for contract owners. Contract owners are division managers or their designees, who initiate, negotiate, monitor, and close out each contract. In contrast, the Administrative Services Division will manage the CMS and oversee the contract monitoring program. Some oversight responsibilities will include notifying contract owners when contracts near their expiration dates, and performing an independent check on invoices against the contract terms. The contract owners are still responsible for the day-to-day contract compliance functions, and ensuring that invoices match the payment terms of the contract.

AREAS IN NEED OF MANAGEMENT'S ATTENTION

Integrating Microsoft Great Plains with the CMS
One area that can be improved is the database management system used to track invoice payments, which is separate from the CMS. The Administrative Services Division uses a Microsoft Access database to monitor the cumulative balances paid to a vendor. These balances are tracked outside of Microsoft Great Plains, LACERA's accounts payables system. Using Microsoft Access creates additional work, because Administrative Services staff must re-enter information from the invoices into an Access database after the information was already entered by Financial and Accounting Services Division ("FASD") staff. FASD staff enters invoice information into Microsoft Great Plains in order to pay invoices.

RECOMMENDATION

1. **The Systems Division work with Administrative Services to integrate Microsoft Great Plains with CMS where practical to minimize redundant work.**

   Management Response
   Systems Division agrees with the recommendation and will work with Admin Services to integrate Microsoft Great Plains with CMS where practical to minimize redundant work. The estimated date for implementing this recommendation is October 31, 2018.

CONCLUSION

LACERA is on the path of accomplishing its contract monitoring program objectives. We did note one recommendation for the Systems Division to work with Administrative Services to integrate Microsoft Great Plains with CMS where practical. Internal Audit will perform a comprehensive audit once the CMS application is fully implemented.

NOTED AND APPROVED

Leisha E. Collins

Leisha Collins, Principal Internal Auditor, on behalf of: **Date:** August 31, 2018
Richard Bendall
Chief Audit Executive

CC:

2018 Audit Committee	*Robert Hill*	*Bernie Buenaflor*
Rick Wentzel	*James Brekk*	*Steven Rice*
Internal Audit Staff	*JJ Popowich*	*Kim Hines*
Roxana Castillo		

LACERA

Version with Audit Committee Comments & Internal Audit Responses

August 31, 2018

TO: Each Member
2018 Audit Committee

Audit Committee Consultant
Rick Wentzel

FROM: Kathryn Ton, CPA, CFE KT
Senior Internal Auditor

FOR: September 12, 2018 Audit Committee Meeting

SUBJECT: **CONTRACT MONITORING PROGRAM STATUS UPDATE**

INTRODUCTION

Internal Audit reviewed LACERA's contract monitoring program as part of the fiscal year 2018 audit plan. This was in response to a prior audit finding in which LACERA continued doing business with a vendor who had an expired contract. Management addressed the internal audit finding in a January 2016 memo to the Operations Oversight Committee ("OOC"), and committed to building a robust contract monitoring process which would prevent such future occurrences. Management's contract monitoring process[(1)] would involve:

(1) Identifying and collecting LACERA contracts
(2) Developing a contract management system to store and monitor existing contracts.

Internal Audit met with management, and learned that the implementation of the contract monitoring program is still in-progress. Therefore, we performed a high-level review of the program at its current state. A more detailed audit will be performed once the program is fully implemented. The purpose of this memo is to update the Audit Committee on (1) management's existing plans and progress and (2) areas in need of management's attention while the rollout is underway.

BACKGROUND

Contract monitoring is an important area of compliance, because an effective contract monitoring program can help manage financial and operational risks when working with third-party vendors. Third-party vendors are contractually obligated to perform services

(1) (1) and (2) are focused on the compilation of contracts for all divisions except the Investments Office. The Investments Office, in conjunction with the Legal Office, maintain and manage investment related contracts. Investments Office staff monitor the contracts of their investment managers and investment related vendors.

within the agreed-upon terms, and LACERA is contractually obligated to remit payment for those services. The inability to do either is a financial and operational risk on LACERA, and opens the door for litigation and other regulatory issues. Management is mitigating those risks by building a contract management system to account for and monitor all existing contracts.

AC QUESTION: Do you consider Purchase Orders to be contracts? If not, what is the dollar maximum of a purchase order at LACERA?
IA RESPONSE: Yes, LACERA considers a Purchase Order to be a contract once the vendor issues an acknowledgement accepting the purchase order terms and conditions.

MANAGEMENT'S PLANS

Based on our review, management is headed in the right direction with the buildout of the contract management system ("CMS") application. Currently, the CMS acts as a repository for LACERA contracts and can accomplish items (1) and (2) above. Upon completion of the CMS, the system can then be beta tested and implemented. In addition, we observed that members from the Executive Office, Administrative Services Division, and Systems Division have developed instruction manuals, forms, and training materials for contract owners. Contract owners are division managers or their designees, who initiate, negotiate, monitor, and close out each contract. In contrast, the Administrative Services Division will manage the CMS and oversee the contract monitoring program. Some oversight responsibilities will include notifying contract owners when contracts near their expiration dates, and performing an independent check on invoices against the contract terms. The contract owners are still responsible for the day-to-day contract compliance functions, and ensuring that invoices match the payment terms of the contract.

AC QUESTION: The CMS is targeted for when?
IA RESPONSE: Management expects deployment by the end of the year.

AREAS IN NEED OF MANAGEMENT'S ATTENTION

Integrating Microsoft Great Plains with the CMS
One area that can be improved is the database management system used to track invoice payments, which is separate from the CMS. The Administrative Services Division uses a Microsoft Access database to monitor the cumulative balances paid to a vendor. These balances are tracked outside of Microsoft Great Plains, LACERA's accounts payables system. Using Microsoft Access creates additional work, because Administrative Services staff must re-enter information from the invoices into an Access database after the information was already entered by Financial and Accounting Services Division ("FASD") staff. FASD staff enters invoice information into Microsoft Great Plains in order to pay invoices.

AC QUESTION: If I am understanding this correctly, CMS is a system being developed by LACERA staff. Given the agency's connections to Microsoft enterprise systems, did staff consider if Microsoft had a product to meet the agency's needs, in lieu of developing a stand-alone and then interfacing it with the Microsoft enterprise system?
IA RESPONSE: CMS is based on an existing LACERA document management platform. Management is customizing the system to meet its specific contract management needs. Management did consider several options including Microsoft. Management determined that the current option best met LACERA's needs.

RECOMMENDATION

1. **The Systems Division work with Administrative Services to integrate Microsoft Great Plains with CMS where practical to minimize redundant work.**

   Management Response
   Systems Division agrees with the recommendation and will work with Administrative Services to integrate Microsoft Great Plains with CMS where practical to minimize redundant work. The estimated date for implementing this recommendation is October 31, 2018.

CONCLUSION

LACERA is on the path of accomplishing its contract monitoring program objectives. We did note one recommendation for the Systems Division to work with Administrative Services to integrate Microsoft Great Plains with CMS where practical. Internal Audit will perform a comprehensive audit once the CMS application is fully implemented.

NOTED AND APPROVED

Leisha E. Collins

Leisha Collins, Principal Internal Auditor, on behalf of: **Date:** August 31, 2018
Richard Bendall
Chief Audit Executive

CC:

2018 Audit Committee	*Robert Hill*	*Bernie Buenaflor*
Rick Wentzel	*James Brekk*	*Steven Rice*
Internal Audit Staff	*JJ Popowich*	*Kimberly Hines*
Roxana Castillo		