STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

May 13, 2016

The Honorable John Allen, Chair
Joint Legislative Audit Committee

The Honorable Judy Burges, Vice Chair
Joint Legislative Audit Committee

Dear Representative Allen and Senator Burges:

Under contract with the Office of the Auditor General, Gallagher Fiduciary Associates, LLC, completed an initial followup of the Public Safety Personnel Retirement System regarding the implementation status of the 18 audit recommendations (including sub-parts of the recommendations) presented in the *Independent Operational Review of the Public Safety Personnel Retirement System (the System) Investment Strategies, Alternative Asset Investment Procedures and Fees Paid to External Investment Managers* released in September 2015 (Auditor General Report No. 15-CR3). As the attached grid indicates:

- 15 have been implemented; and
- 3 are in the process of being implemented

Our Office will conduct an 18-month followup with the System on the status of the recommendations that have not yet been fully implemented.

Sincerely,

Dale Chapman, Director
Performance Audit Division

DC:ka
Attachment

cc: Jared Smout, Administrator
Public Safety Personnel Retirement System

Public Safety Personnel Retirement System Board of Trustees

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

Independent Operational Review of the Public Safety Personnel Retirement System (the System) Investment Strategies, Alternative Asset Investment Procedures and Fees Paid to External Investment Managers

Auditor General Report No. 15-CR3

Initial Follow-Up Report

Recommendation	Status/Additional Explanation
Task 1.c: Determine the processes the System uses to monitor how well its investment strategies and objectives are performing and guide it toward meeting its expected rates of return	
Gallagher recommends that the System consider including consecutive calendar year performance for the most recent 10 years as well as the inception to date returns in its quarterly investment reporting.	**Implemented at 6 months**
Task 1.h: Determine the causes for any underperformance, including any procedures or requirements that limit the System's investment strategies	
1. Given the poor performance of the overall real estate portfolio, in particular the Joint Venture investments, Gallagher recommends that the System staff continue to work with its specialty consultants to review and possibly restructure the portfolio as feasible.	**Implemented at 6 months**
2. The System should continue to monitor performance of the Trust and the underlying strategies, and adjust its asset allocation and restructure asset classes as appropriate and reasonable.	**Implemented at 6 months**
Task 2.a: Identify the processes and other controls the System uses for selecting, developing terms and conditions for, monitoring, and valuing investments, and terminating alternative investment manager contracts	
The Fund due diligence procedure was approved in 2014 and our review shows that it was due to be reviewed in 2015. Gallagher recommends following the annual review schedule that is listed and documenting each annual review.	**Implemented at 6 months**

Recommendation	Status/Additional Explanation
Task 2.b: Determine whether the System used the identified processes and controls for alternative investment contracts the System entered into during fiscal years 2005 through 2014	
1. Gallagher recommends creating an Executive Summary for each partnership that reflects the 12 areas of focus outlined in the due diligence process (FDD2014). The summary should indicate that each area has been reviewed and completed as outlined in the process document. The summary should be included in all due diligence records, in both electronic and hardcopy form, as appropriate.	**Implemented at 6 months**
2. The Internal Audit and Compliance Officer should review, at least annually, each investment that has been approved by the administrator, staff, and consultants for the System portfolio. The scope of this review should mirror that of the initial process documented in the Review of Investment Due Diligence Report dated March 18, 2013. Future annual reviews should be presented to the Board of Trustees.	**Implementation in process** Review of the System's due diligence process began in March 2016. System staff anticipate that the review will be completed in June 2016.
3. Gallagher recommends updating and revising the due diligence procedures on an annual basis. In the next revision of the procedure outlined in FDD2014, Gallagher specifically recommends:	
a. Expand the staff memo to specifically include information on how the investment was identified and selected for additional due diligence.	**Implemented at 6 months**
b. Include a note in the FDD2014 procedure that very clearly specifies that the Meeting Scorecard is only relevant for new firms where the System does not have an existing relationship.	**Implemented at 6 months**
c. When making an additional investment with an existing manager relationship, ask the investment manager to verify, in writing, any material changes to the firm or investment process since the time of the most recent investment by the System.	**Implemented at 6 months**
d. Either remove or clarify the reference to Board of Trustees meetings, as appropriate.	**Implemented at 6 months**
Task 2.c: Determine if the System collects and utilizes monitoring data to improve subsequent contracts	
1. The System should continue to utilize both firms in the legal review of fund terms and documents, as appropriate, and focus on key legal partners, as opposed to casting a wide net with several approved vendors.	**Implemented at 6 months**

Recommendation	Status/Additional Explanation
2. The System should periodically review each service provider, which can help ensure that the firms continue to serve in the Trust's best interest. Gallagher recommends that such a review be conducted at least every 3 years.	**Implementation in process** The System conducted an annual review of its service providers in June 2015 and has a practice to annually review these service providers in conjunction with the System's annual review of its budget. Auditors will follow-up at 18 months to confirm that the System is continuing to conduct these annual reviews.

Task 2.d: Compare the System's processes and other controls for selecting, monitoring, and terminating alternative investment manager contracts and valuing investments to best practices, including, but not limited to, industry standards

1. Gallagher recommends the System continue with its commitment to regularly update and improve its due diligence procedures, particularly in light of the decision-making responsibilities that have been granted to the administrator, staff, and consultants for the System's portfolio.	**Implemented at 6 months**
2. A periodic review of all service providers (both investment advisors and legal representation) would help to ensure that the System continues to receive high-quality guidance and advice at a reasonable cost. Gallagher recommends that these reviews be conducted at least every 3 years.	**Implementation in process** The System conducted an annual review of its service providers in June 2015 and has a practice to annually review these service providers in conjunction with the System's annual review of its budget. Auditors will follow-up at 18 months to confirm that the System is continuing to conduct these annual reviews.

Task 3.a: Identify the processes and other controls the System uses for accepting and/or negotiating external investment manager fees

The documented procedures mentioned in Section 3.a should include a standard method for documentation of fee negotiation. The documentation should match what is already being done, including the proposed fees from the manager before negotiation, the System office proposed fee structure, and the final agreement.	**Implemented at 6 months**

Task 3.b: Determine whether the System used the identified processes and controls for accepting and/or negotiating external investment manager fees for contracts the System entered into during fiscal years 2005 through 2014

The documented procedures mentioned in Section 3.a should include a standard method for documentation of fee negotiations. The documentation should match what is already being done, including the proposed fees from the manager before negotiation, the System office proposed fee structure, and the final agreement.	**Implemented at 6 months**

Recommendation	Status/Additional Explanation
Task 3.c: Compare the System's processes and other controls over setting external investment manager fees to best practices, including, but not limited to, industry standards	
Gallagher recommends that the System begin by giving a person or group responsibility for fee policy and negotiations. Once established, this group can also be tasked with documenting procedures that include the best practices outlined by the GFOA. The group should draft a formal report on fee negotiations to be completed prior to the execution of each investment agreement.	**Implemented at 6 months**
Task 3.d: Identify the reasons for and impact of any inadequate processes or other controls	
Gallagher recommends the documentation of fee negotiations should include acknowledgement of where the manager fee ranks compared to an appropriate peer group. Above-median fees should be justified by the perceived ability of the manager to add value over the appropriate benchmark.	**Implemented at 6 months**