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# **City of Milwaukee Employees' Retirement Services**

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## ***Investments Audit Report***

**MARCH 17, 2016**

**EXPERIS FINANCE  
RISK ADVISORY SERVICES  
WISCONSIN OFFICE**

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## **EXECUTIVE SUMMARY**

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### **Background**

At the direction of the Administration and Operations Committee, an Investments Audit was performed during the period January 21 – February 14, 2016. The City of Milwaukee Employees' Retirement System (ERS) has the responsibility of administering the benefits of its member constituency, which is comprised of employees and retirees of the City of Milwaukee and its related agencies.

ERS manages its investments in accordance with the prudent investor rule, ERS Statement of Investment policy, and legislative statutes. ERS utilizes third party investment managers to allocate assets, and also uses an investment consultant and custodian.

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### **Audit Scope & Objectives**

The objective of the Investment audit encompassed the review of processes and controls related to the following:

- Oversight of investment manager performance
- Administration of contractual provisions between ERS and third party investment managers, custodian, and investment consultant
- Monitoring for compliance with the ERS Statement of Investment Policy
- Reconciliation of investment reporting between the custodian and investment managers
- Calculation, approval, and payment of investment manager and other third party fees

Various audit techniques were used to assess and examine the effectiveness of the ERS internal control environment. Audit techniques included conducting interviews with ERS personnel, observation of performance of required procedures and controls, and examination of related documentation.

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### **Procedures Performed**

The following procedures were performed during the audit.

- Obtained contracts for a sampling of 18 investment managers and investment consultants that have been executed since the last audit was performed in 2014. Reviewed contractual provisions including fees and insurance requirements, and verified contracts were signed by the investment managers/consultant and appropriate ERS representative(s).
- Reviewed quarterly performance reporting for a sample of 12 current investment consultants.

- Obtained and reviewed the quarterly performance reporting packages for a sample of 12 investment managers. Reviewed ERS calculated manager returns, benchmarking index returns, and values of holdings against those reported by the investment consultant and custodian for accuracy on a sample basis.
- Verified that quarterly investment manager holdings statements are reconciled to the Northern Trust custodian reporting statement.
- Obtained the SSAE 16 report from Northern Trust to confirm that the custodian maintains adequate internal controls over trades and movements, and that ERS reviews to ensure that the client control considerations have been sufficiently addressed.
- Reviewed the SSAE 16 reports for the various Investment Managers contracted by ERS to manage pension assets. Determined that ERS reviews to ensure that the client control considerations have been sufficiently addressed.
- Confirmed that sufficient position backup and cross training occurs in the investment area and is supported with supervisory review.
- Reviewed the process to monitor investment manager compliance with the ERS Statement of Investment Policy through the use of the Northern Trust Compliance Analyst application.
- Reviewed investment manager due diligence schedule and a sample of 14 due diligence reports to confirm the biannual review process.
- Reviewed custodian Northern Trust contract and amendments to compare the securities lending fees stipulated by these agreements to those being charged.
- Obtained invoicing for a sample of 10 investment managers and obtained private equity partnership financial statements to verify that ERS is being charged in accordance with the terms of the agreements with these third parties.

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### **Overall Assessment**

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ERS management has implemented a solid internal control environment for its Investment Management process. Based on the results of our review we identified one internal control enhancement recommendation:

- Develop and implement an internal SSAE 16 review and evaluation process, based on the service provider's impact on ERS's internal control environment.

In addition, we also made an observation that Experis believes would improve and enhance the Investment Management internal control framework.

Audits are only one part of a comprehensive risk management and control program. Recommendations are provided with the objective to assist the Board, Audit Committee and management in the effort to eliminate, reduce or mitigate overall risks. The procedures performed, findings, and recommendations, including management's written response, are included in the next sections of the report.

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**OBSERVATIONS, RECOMMENDATIONS & MANAGEMENT'S RESPONSE**

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**1. Internal Control Enhancement: Review and Evaluation of SSAE 16 Service Auditor Reports**

<b>Risk Severity</b>	<b>Low – Medium</b>
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Recently, ERS has started to receive SSAE 16 (SOC 1) Service Auditor Reports from some of its third party Investment Managers. These third party service providers often provide functionality within a process deemed to be financially significant. As a result, a CPA firm is often asked to provide and issue an attestation on the relevant controls of the third party and the user's responsibilities related to those controls. The AICPA standard that defines this reporting is the Statement on Standards for Attestation Engagements 16 (SSAE 16) Service Auditor Reports. The SSAE 16 report is designed to provide organizations the ability to place reliance on the controls reported, and for the users to understand the potential risks with the services provided.

Because this is a relatively new process for this industry, there are no industry guidelines or requirements to obtain SOC 1 reports. As a result, ERS does not have a formalized process for identifying, obtaining and assessing the SSAE16 reports that their service providers may provide. Additionally, there is no formal process for alternative procedures, should a provider not perform and issue an SSAE 16 report.

**Recommendation:**

While there are no industry requirements to obtain SOC 1 reports, some Investment Managers are beginning to send SOC 1 reports. To ensure ERS has an understanding of the internal control environment of the systems and services it relies upon, we recommend ERS develop and implement an SSAE 16 evaluation process similar to what is utilized in other industries. As part of this process, also consider expanding and enhancing the Due Diligence questionnaire currently utilized by the Investment Department.

**Management Response:**

CMERS investment team will modify its due diligence questionnaire going forward to ask each investment manager:

- If you perform a SSAE 16/SOC1, please disclose any exceptions that were noted in the report.

Asking each manager for disclosure is a practice that is performed for other due diligence items (i.e. portfolio compliance for investments within commingled vehicles, MFN assurances, personnel turnover, etc.). After conducting research on this topic that included correspondence with other public pension plans and Callan, Staff feels comfortable that a reasonable course for CMERS to follow at this time is to rely on:

- 1.) Due diligence currently performed by Callan, and;
- 2.) The modified disclosure CMERS will require as noted above.

In addition, CMERS will attempt to stay in tune with what its peers do going forward with regards to SSAE 16/SOC1 review and will be open to modifying this approach as necessary.

It is important to note that CMERS does not currently request copies of SSAE 16/SOC1 from its investment managers, nor are investment managers required to complete a SSAE 16/SOC1 as part of any contractual or regulatory provision. Any SSAE 16/SOC1 currently received by CMERS is provided to Staff by the manager voluntarily, likely to impress investors such as CMERS for going above and beyond what's required.

Also of note is that, through CMERS correspondence with some of its peers and Callan, reviewing each investment manager's SSAE 16/SOC1 has not been adopted as a common practice within the investment industry. While it's not currently a common practice to review the SSAE 16/SOC1 of investment managers, it is a current practice to review the SSAE 16/SOC1 of custodians because custodians are in possession of the assets. With the exception of certain alternative asset classes (real estate, private equity, hedge funds), all of CMERS' assets are custodied at major banks including: Northern Trust (about 60%), State Street (about 20%), Citigroup (about 4%), Bank of New York Mellon (about 1%), and JP Morgan (about 1%). In the case of CMERS, CMERS' external auditors request a copy of Northern Trust's SOC1 report as part of every annual financial audit. Callan also has specialists at its firm that evaluate custodians (especially all of the major banks) and regularly keep Staff up to date on new developments.

Finally, it's worth noting that this discussion, which was spurred by these comments from Experis, has helped Staff brainstorm ideas that potentially can enhance the internal controls CMERS has around its real estate program. These ideas will be discussed with Callan as they conduct their evaluation of CMERS' real estate program later in 2016.

**Individual Responsible:** David Silber

**Estimated Completion Date:** Completed for now. We have recently made the change to the due diligence questionnaire as noted in the Manager Response. We will attempt to keep in touch with peers and will be prepared to evolve our process as necessary.

## **1. Observation: Investment Calendar**

During the Investment audit, Experis observed that the Investment Department does not utilize a Calendar to chart and schedule future work assignments, presentations, reports and other sundry analyses. The adoption of a work driven Calendar can provide definition and enhance processes that are not otherwise defined by procedural actions.

Consider adopting a comprehensive Calendar that identifies and schedules all of the work and deliverables that need to be prepared during Calendar year. The benefits of developing and implementing a Calendar can include;

- A deliverable driven Calendar can provide a framework for processes that are not otherwise defined by standard procedural instructions (SPI's).
- Provide a centralized means to communicate both short term and long term department goals in order to ensure that department deliverables are performed and provided without interruption.
- Serve as a succession bridging document in the event of unplanned staff turnover.
- Support a basic framework for investment staff development / training