



# ARIZONA STATE RETIREMENT SYSTEM

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*Paul Matson*  
Director

## MINUTES OF A PUBLIC MEETING OF THE ARIZONA STATE RETIREMENT SYSTEM OPERATIONS AND AUDIT COMMITTEE

HELD ON  
Tuesday, September 8, 2015  
10:30 A.M., Arizona Time

The Operations and Audit Committee (OAC) of the Arizona State Retirement System (ASRS) met in public session in the 14th Floor Conference Room of the ASRS Office, 3300 North Central Avenue, Phoenix, Arizona 85012. Mr. Jeff Tyne, Chair, called the meeting to order at 10:30 a.m.

### 1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Jeff Tyne, Chair  
Dr. Richard Jacob

Absent: Mr. Clark Partridge

A quorum of the Committee was present for the purpose of conducting business.

### 2. Approval of the Minutes of the July 14, 2015 Public Meeting and Executive Session of the OAC

**Motion:** Dr. Richard Jacob moved to approve the minutes of the July 14, 2015 OAC public meeting and executive session of the OAC. Mr. Jeff Tyne seconded the motion.

By a vote of 2 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

### 3. Presentation and Discussion Regarding the Performance Audit and Sunset Review Reports Published by the Office of the Auditor General

After opening remarks on the topic, Mr. Anthony Guarino, Deputy Director and Chief Operations Officer, introduced Ms. Lisa King, Policy Analyst, who provided the following summary:

#### AUDIT PROCESS

The sunset review period covered fiscal years 2005 through 2014. The Office of the Auditor General (OAG) retained a consultant, Arthur J. Gallagher & Company (AJG), to conduct the investment management operational review; therefore, two separate reports were created.

For their report, the OAG auditors ultimately focused on the agency's financial condition and long-term sustainability. State statutes, administrative rules, policies, procedures, and ASRS records were reviewed and interviews were conducted. Additionally, criteria from other states, best practices, and literature were obtained. For comparison purposes, peer retirement plans were selected based primarily on market value of assets, retired to active member ratio and investment return assumption. Based on these criteria, the ASRS peers were identified as:

- Public Employees' Retirement System of Mississippi
- Public Employees' Retirement System of Nevada-Regular Employees

- South Carolina Retirement System
- Tennessee State Employees, Teachers and Higher Education Employees' Pension Plan

The AJG report focus was the agency's investment strategies, alternative asset investment procedures, and fees paid to external investment managers. Materials reviewed included investment policies and procedures, due diligence reports, consultant and investment manager contracts, meeting minutes, performance reports, benchmark returns, and external manager fees negotiated/paid. For each investment reviewed, AJG was looking for:

- Sourcing
- Due Diligence
- Decision Making
- Governance
- Monitoring

During the review process, periodic meetings were held with agency, OAG, and AJG staff to discuss findings to date and clarify issues. The Board was kept abreast of proceedings via Executive Session updates in February and May 2015.

Draft reports were issued by the OAG and AJG in June 2015. Constructive discussions were held during in-person exit conferences and the agency continued to work with both the OAG and AJG until the final reports were issued. The agency's written responses to the findings and recommendations were published as a section in both final reports.

The Public Safety Personnel Retirement System (PSPRS) underwent a concurrent sunset review. AJG also performed their investment management audit. The OAG anticipates publishing the PSPRS performance audit and sunset review reports in mid-September.

#### FINAL REPORT FINDINGS AND RECOMMENDATIONS

The final reports were published on the OAG website on August 20, 2015. In the Sunset Factor Analysis section of their report the OAG cites that "ASRS has generally met its statutory objective and purpose..." (see Sunset Factor #2) and that "terminating the ASRS would significantly harm the public welfare" (see Sunset Factor #10).

Highlights of the reports' findings and recommendations include:

- Performance Audit and Sunset Review report by the OAG:
  - The ASRS plan is not fully funded, but steps have been taken to improve its long-term sustainability;
  - Additional actions can enhance ASRS plan's financial condition and long-term sustainability;
  - The ASRS and Board should periodically review its actuarial cost method;
  - The ASRS should ensure future permanent benefit increases do not impact plan sustainability;
  - The ASRS should enhance procedures surrounding the employer termination incentive program; and
  - The ASRS should enhance some of its information technology (IT) practices.
- Independent Operational Review of the Arizona State Retirement System's (ASRS) Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers report by AJG:
  - The eight percent actuarial rate should be discussed annually with the actuary to ensure appropriateness;
  - The ASRS should conduct annual reviews of the Strategic Investment Policy;
  - Sourcing information and screening criteria should be included in the final

- investment memo for each partnership;
- o All specialty consultants should adopt a due diligence checklist; and
- o A standard method for documenting fee negotiations should be implemented.

For the 10 years evaluated:

- The ASRS plan's funded status decline was less severe than three of four peers; only Tennessee had a consistently higher funded status. As of June 30, 2014 ASRS's funded status was 76.3 percent; Tennessee's funded status was 93.34 percent as of July 1, 2013 (last valuation available).
- Of the four peers, only Mississippi had a larger percentage point decline in funded status (16%). ASRS experienced a 10.8 percent decline.

AJG found that current ASRS "practices and procedures are reasonably consistent with industry standards and generally in line with many best practices." Additionally, it was cited that the agency has a well-diversified asset allocation and investment structure and investment staff follow a comprehensive performance monitoring policy.

Overall, the results in both reports were positive and implementing the recommendations may further enhance ASRS operations and sustainability. The findings and recommendations of both the OAG and AJG were agreed to by the agency although in a few instances the agency will implement the recommendations using a different method or will wait to implement until pending litigation is concluded.

- Review of service providers (both investment and legal) will coincide with the procurement cycle rather than every three years as recommended by AJG.
- The ASRS will determine how best to implement the OAG recommendation to enhance procedures to identify employer termination incentive programs and assess the cost of any resulting unfunded liability to employers once current legal proceedings conclude.

#### NEXT STEPS

The next step in the process will be a public hearing before the joint house and senate committee of reference (COR). At this hearing the COR is expected to vote on whether to recommend the full Legislature continue, modify, or terminate the agency. It is anticipated the vote will be to continue the ASRS at which time the COR will be responsible for preparing the related legislation.

The Joint Legislative Audit Committee (JLAC) requires the agency submit to the OAG a written explanation of the status of all recommendations within six months after the August 20, 2015 publication date of the audit reports. Depending on the progress reported at six months, the ASRS may be required to provide additional information to the OAG at 18 months and again until the recommendations are implemented.

Mr. Guarino, Ms. King, Mr. Gary Dokes, Chief Investment Officer, and Mr. Paul Matson, Director, responded to questions from the Trustees.

#### **4. Review of Recently Conducted Audits**

Mr. Bernard Glick, Chief Internal Auditor, reviewed the following audits conducted by the IAD.

- **Central AZ Irrigation and Drainage District – Employer Audit**  
The IAD had one finding from the Central AZ Irrigation and Drainage District audit. The employer agreed with the findings and IAD's recommendations.

- **Town of Miami – Employer Audit**

The IAD had three findings from the Town of Miami audit. The employer agreed with the findings and IAD's recommendations.

- **Qualified Domestic Relations Orders – ASRS Processes**

The IAD audit revealed that the ASRS objectives were met; however, one recommendation was made by IAD. The ASRS management agreed with the IAD's recommendation.

## **5. Request for Future Agenda Items**

To schedule another meeting prior to the upcoming November 10 meeting to:

- Determine the optimal Strategic Plan goals for the ASRS Health Insurance
- Determine the optimal application of whole case underwriting and cross-subsidization in setting premiums
- Determine the optimal utilization and allocation options of the Retrospective Rate Adjustment Agreement Fund

## **6. Call to the Public**

There were no members of the public in Phoenix or Tucson.

## **7. Adjournment of the OAC**

**Motion:** Dr. Richard Jacob moved to adjourn the meeting at 11:15 a.m. Mr. Jeff Tyne seconded the motion.

By a vote of 2 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

Respectfully Submitted,

ARIZONA STATE RETIREMENT SYSTEM

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Melanie Alexander  
Committee Administrator

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Anthony Guarino  
Deputy Director and Chief Operations Officer