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CULTURE OF COMPLIANCE

Each year the California Public Employees' Retirement System (CalPERS) compiles an Annual Compliance Report for inclusion in the Comprehensive Annual Financial Report (CAFR). This year's report highlights activities and accomplishments for the Fiscal Year (FY) ending June 30, 2017.

Compliance is embedded into our strategy, culture, and day-to-day business operations as our activities and accomplishments directly support our organization's business plan and core values.

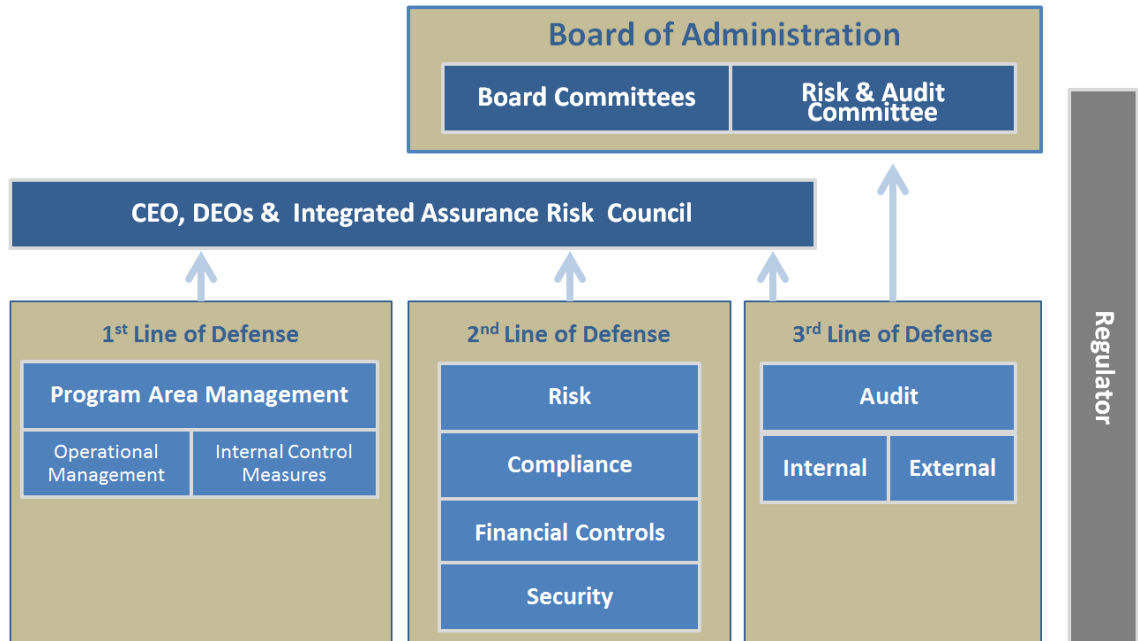
CalPERS established a compliance program in 2004 to support our commitment to strong ethics, compliance, and risk management practices. In 2015, CalPERS developed a new multi-year compliance plan, building upon the already effective compliance practices in place. This five-year plan accounts for current industry best practices as well as input from CalPERS leadership in establishing compliance focused priorities.

During the first two years of implementation, CalPERS developed a framework and tools aimed at enhancing our control environment, addressing compliance risk exposure, and improving the management of policies and delegations of authority. Additionally, CalPERS has focused on fostering a compliance-aware culture through communication, education, and training. Fiscal Year 2016-17 was "Year Two" of our five-year plan, emphasizing expanded protocols and processes for policy management, reporting standards, and monitoring.

Compliance awareness, risk management and internal controls are integral to cultivating a high-performing, risk-intelligent, and innovative organization. To implement our governance, risk, and compliance practices, CalPERS have embraced an Integrated Assurance Model to promote a multi-faceted approach to compliance awareness and accountability. The model centers on a Three Lines of Defense framework (see Figure 1), which promotes collaboration and an increased understanding of roles and responsibilities to detect, prevent, and correct instances of noncompliance.

- **First Line of Defense** – The first level of the control environment are the program areas, which perform day-to-day risk management activities.
- **Second Line of Defense** – Oversight functions, such as Enterprise Compliance and Enterprise Risk Management, set direction, define policy, and provide assurance.
- **Third Line of Defense** – Internal and external audits offer an independent challenge to the levels of assurance provided by program areas and oversight functions.

INTEGRATED ASSURANCE MODEL: THREE LINES OF DEFENSE



(Figure 1)

The Integrated Assurance Model helps clarify roles and responsibilities and promote ownership of compliance throughout the organization. Through the Three Lines of Defense, CalPERS encourages a culture of “doing the right thing.” By fostering a work environment based on our core values of quality, respect, integrity, openness, accountability and balance, CalPERS also recognizes that “compliance is everyone’s responsibility.”

FISCAL YEAR 2016-17 HIGHLIGHTS

Fiscal Year 2016-17 focused on expanding protocols and processes for operational control, policy management, and reporting standards. Programs launched many initiatives and activities that laid the foundation for long-term success, focusing on five key areas: (1) standards and codes, (2) risk assessment and priorities, (3) operating events and incident management, (4) monitoring and testing, and (5) reporting and disclosures. These key areas provide the foundation for our compliance efforts and will continue to remain a focus for multiple years to strengthen CalPERS’ culture of compliance.

FIRST LINE OF DEFENSE

The First Line of Defense in any control environment is the management and team members in the functional program areas, who are responsible for the performance of activities. In addition to performing day-to-day operations, the functional program areas are responsible for compliance and risk mitigation. Highlights of our program area activities are described below.

HEALTH ADMINISTRATION

In FY 2016-17, CalPERS implemented health benefit delivery policies and procedures in compliance with the administration of the Public Employees' Medical and Hospital Care Act (PEMHCA) and Affordable Care Act (ACA).

In compliance with the Budget Act of 2016, CalPERS publicly released unadjusted and risk-adjusted premiums during the May 2017 Pension and Health Benefits Committee meeting.

Additionally, CalPERS developed and submitted reports to meet statutory requirements including:

- An annual report to the Legislature, State Controller, Director of Finance, and Legislative Analyst Office submitted within 100 days of adopting annual health premium increases and decreases that describes methods employed to moderate annual increases in premiums pursuant to the Budget Act of 2015 (Stats. 2015, Ch. 10, Sec. 2.00, Item 7900-015-0822 (2)).
- An annual report to the Legislature pursuant to California Government Code Section 22866(a). This annual report was a comprehensive look at the CalPERS health benefits program due and submitted on November 1, 2016, and will be reviewed annually thereafter.
- A one-time report to the Legislature covering the administration of the health care premium risk adjustment procedures for premium years 2014 - 2017. The report is inclusive, as authorized by paragraph (3) of subdivision (f) of Section 22850 of, and Section 22864 of, the Government Code, and related rules and regulations pursuant to the Budget Act of 2016 (Item 7900-001-0822 (2)) and was due and submitted on October 1, 2016.

PENSION ADMINISTRATION

In the CalPERS Benefit Services Division, over two million participant birthdates were securely cross-referenced with Social Security data through a third-party vendor, identifying less than one percent of birthdates as discrepant and taking action to resolve. This effort ensured compliance with benefit administration rules and improved the accuracy of benefits paid. The minimal number of discrepancies validated that proper internal controls are in place.

In our Customer Services and Support Division, CalPERS published a compliance handout distributed to business partners at the Educational Forum as a straightforward reference to support compliance in five key areas: accuracy, timeliness, verification, awareness, and security.

INTERNAL OPERATIONS

Financial Controls & Reporting

To meet statutory requirements, CalPERS also developed and submitted the following financial reports:

- Administration of the health care premium risk adjustment procedures for premium years 2014 to 2017. This one-time report was submitted on October 1, 2016 to the Chairperson of Joint Legislative Budget Committee, the chairpersons of the committees and subcommittees in each house of the Legislature that considers PERS' budget and activities, the Controller, the Director of Finance, and the Legislative Analyst pursuant to the Budget Act of 2016 (Stats. 2016, Ch. 23, Item 7900-001-0822 (2)).
- Health Benefits Program Administrative Costs Zero-Based Budgeting Review to the Department of Finance as part of the 2017-18 Governor's Budget development to evaluate program objectives, workload metrics, cost allocation methodologies, reserve levels, personnel services, and operating expenses and equipment pursuant to the Budget Act of 2016 (Stats. 2016, Ch. 23, Item 7900-001-0822 (3) and Item 7900-001-0950 (3)).

In compliance with the enterprise-wide policy management framework, the Actuarial Office implemented the new consolidated Actuarial Cost Method Policy and the Actuarial Amortization Policy in December 2016. The two consolidated policies generally keep the same content of the

past policies but add the flexibility to apply dollar billing to the unfunded liability portion of all public agency plans. The policies also help ensure consistency with actuarial and policy management best practices.

Investment Office

Investment Compliance and Operational Risk (ICOR) serves as an embedded compliance function and assists our Investment Office (INVO) employees by ensuring compliance with key policies, laws, and regulations that impact the Investment Office.

In Fiscal Year 2016–17, ICOR organized and administered investment compliance training for Investment Office employees. The training addressed various ethics and conflicts of interest-related topics including approval of outside employment and post-employment restrictions applicable to employees.

The ICOR team led strategic projects to evaluate the existing control environment of INVO's trade order management systems, broker selection, and evaluation processes. Additionally, ICOR assumed responsibility for compliance with all divestment initiatives, including associated Board and legislative reporting.

Human Resources

In FY 2016-17, CalPERS attained an enterprise-wide annual mandatory training completion rate of 99.5 percent, as of July 1, 2017. The training included Health Insurance Portability and Accountability Act (HIPAA), Information Security Awareness, and Working Values: Ethical Decision Making.

Education and Training

To enhance education and training, CalPERS completed a Lean 6 Sigma Contract Compliance Project that aims to eliminate waste and boost project efficiency. This resulted in quality assurance checks for every CalPERS contract. It also helped successfully train Operations Support Services contract analysts, as well as improve templates, procedures, checklists, and contract folders. In January 2017, an audit was performed and all contracts were in compliance.

As part of the goal to increase compliance knowledge across CalPERS, team members from Enterprise Compliance, Customer Services & Support and Operations & Technology Services attended the Society of Corporate Compliance and Ethics academy. After completing the

academy program and sitting for the examination with the Compliance Certification Board, we now have additional Certified Compliance and Ethics Professionals in the organization.

SECOND LINE OF DEFENSE

CalPERS Enterprise Compliance Division and Enterprise Risk Management Division partnered and collaborated under the Second Line of Defense to provide oversight, guidance, and monitoring of governance, risk, and compliance activities. As a result of this partnership, we are able to support the organization in mitigating strategic and operational risks along with strengthening the organization's control environment and promoting strong ethical business practices. To demonstrate this alignment, both divisions work closely together to develop and implement their annual plans.

The Office of Audit Services, while independent and considered the Third Line of Defense, partnered with the Risk and Compliance divisions during the annual risk assessment process to strengthen their understanding of risks and mitigation strategies. The participation of the Office of Audit Services will ultimately help to maximize integrated assurance practices.

ENTERPRISE COMPLIANCE

The purpose of the Enterprise Compliance Division is to ensure that CalPERS maintains compliance with the letter and spirit of all applicable laws and regulations, in partnership with program areas. The oversight role of the Enterprise Compliance Division, as a Second Line of Defense, includes defining and overseeing a compliance program that:

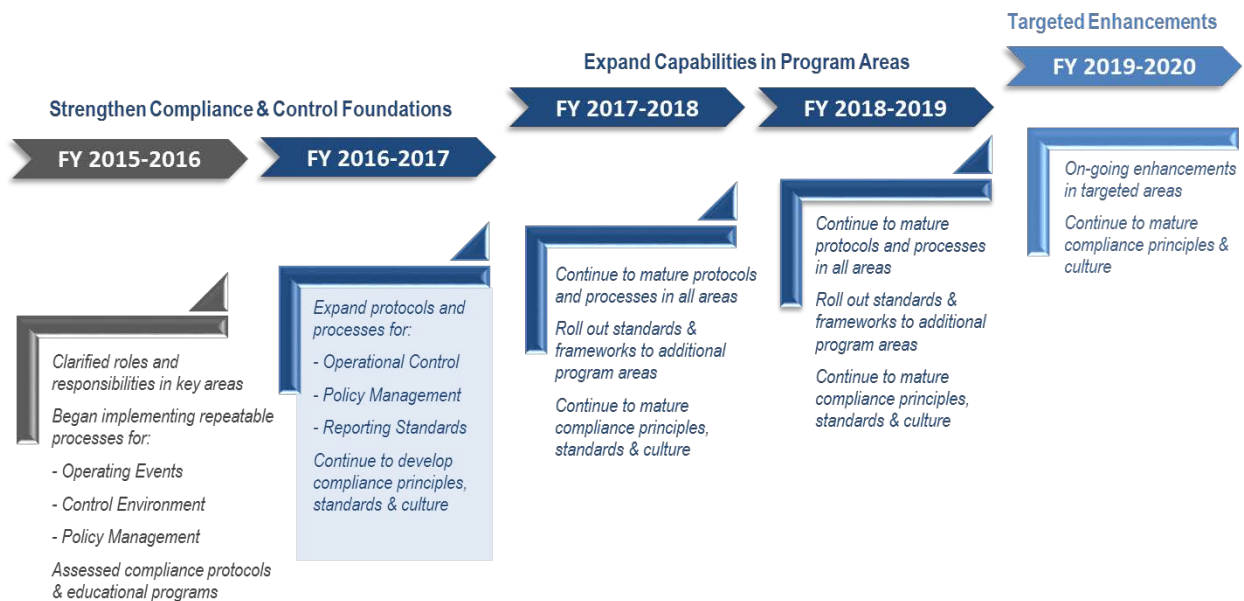
- Mitigates and monitors risks
- Establishes effective policies and procedures
- Provides training and communication
- Reinforces behavioral expectations
- Oversees allegations of misconduct

Through increased dialogue and awareness with program management, the Enterprise Compliance Division:

- Strengthened protocols and knowledge for CalPERS' ethics rules
- Continued to clarify roles and responsibilities among team members, management, and control areas

- Established governance protocols for management to clarify roles and promote effective decision making
- Hired and developed knowledgeable compliance “champions”
- Improved compliance capabilities, resulting in strong internal control processes

The implemented Five-Year Compliance plan is aimed at building and enhancing compliance capabilities to mature the program and is consistent with changes in the broader compliance landscape (see Figure 2). The compliance plan focuses on strengthening our compliance and ethics program by fostering a culture of compliance, clarifying the compliance governance structure, and providing our Board and management with compliance tools and information to fulfill their oversight responsibilities.



(Figure 2)

CalPERS continued to implement embedded compliance and risk programs throughout the organization. In FY 2016-17, embedded compliance and risk liaisons from the Financial and Benefits Programs Policy and Planning branches joined previously implemented embedded programs from the Investment, Operations and Technology, and Customer Services and Support branches. The embedded compliance and risk liaisons are responsible for working directly with their respective program areas and Enterprise Compliance and Risk divisions to enhance CalPERS’ ability to identify and resolve compliance issues.

Enterprise Compliance Oversight and Monitoring

Monitoring and Testing Compliance

In FY 2016-17, CalPERS launched the first of a series of targeted compliance reviews to conduct compliance assessments of complex, cross-branch functions. This first targeted compliance review focused on reducing risk within the contracting and vendor management process. The review was conducted in cooperation with the embedded compliance team Operations and Technology Branch and spanned eleven divisions and functional areas. Recommendations from the review will serve to strengthen internal controls and increase operational efficiency.

The CalPERS Personal Trading Regulations require that CalPERS covered persons and their spouses or registered domestic partners disclose personal investment holdings and use a personal trading pre-clearance system (2 CCR § 558.1). This requirement is intended to safeguard against trading with material non-public information and ensure that CalPERS meets our fiduciary obligations to our fund and members. Enhanced education resources and escalation procedures for personal trading oversight resulted in a 95 percent decrease in violations to CalPERS Personal Trading Regulations since January 2015. Enhanced communications, education and reporting, as well as small group training sessions around CalPERS Personal Trading rules were launched in FY 2016-17.

Enterprise Ethics Program

Conflicts of Interest

The Political Reform Act (Cal. Gov. Code § 81000 et seq.) requires CalPERS to adopt and periodically update a Conflict of Interest Code (the Code). The Code designates positions at CalPERS that are required to file a Statement of Economic Interests - Form 700. Additionally, the Code requires that any consultant who makes or takes part in making of governmental decisions, or that manages public funds must file Statements of Economic Interest disclosures. In FY 2016-17, Enterprise Compliance completed a reconciliation audit of vendor and consultant conflict of interest filings. The Enterprise Ethics Program also began offering monthly small group training sessions for CalPERS employees on the Conflict of Interest Code and disclosure requirements.

Ethics Helpline

CalPERS maintains and monitors a third-party hosted Ethics Helpline that provides a means to confidentially, anonymously, and securely report allegations of unethical behavior. In compliance with the Citizen Complaint Act of 1997 (Cal. Gov. Code § 8330 et seq.). CalPERS

online also provides a plain-language online form that members of the public may use to submit comments, complaints, or suggestions about our performance. In FY 2016-17, Enterprise Compliance developed system enhancements to improve hotline allegation tracking and reporting. This resulted in improved Board reporting and enhanced transparency for the organization.

Policy and Delegation Management

CalPERS has established enterprise-wide standards for delegations of authority and policy management consistent with professional best practice.

Policy Management

In FY 2016-17, CalPERS developed and finalized policy standards and education around policy governance and development. Enterprise Compliance collaborated with 18 program areas, performing a holistic review of CalPERS policies and offered guidance on organization and structure. Additionally, the Enterprise Policy Workgroup was formed to consult on policy standards, escalation processes, and stakeholder engagement; ensuring that governance was consistently applied and appropriate stakeholders were brought into the development process.

This past year, the Enterprise Compliance Division worked in partnership with program areas to develop and implement an official legislation implementation policy. The policy ensures the appropriate steps are taken when new legislation passes and that all impacted program areas are in compliance with reporting requirements and statutes.

Delegation Management

Delegation of Authority standards were developed and finalized across the organization. All delegations of authority for CalPERS executives and senior managers were updated to ensure alignment with the new standards. All Board committee delegations were also reviewed to verify the appropriate standards were met.

Compliance Education and Communication

We have reignited awareness of compliance principles throughout our organization to promote a culture of compliance. This was done by expanding our channels of communication through tools such as the intranet, internal social media page (the SPARK), and enhanced classroom training.

In FY 2016-17, Enterprise Compliance collaborated with the Office of Public Affairs to finalize the development of six informal discussion guides that facilitate compliance and ethics discussions among team members and front-line supervisors. The discussion guides tie compliance and ethics best practices to CalPERS existing core values through a series of easy to understand exercises and scenarios.

CalPERS conducted three Annual Compliance Training sessions for executives and senior managers with a focus on conflicts of interest, travel, and outside employment. To complement the annual training CalPERS developed compliance onboarding training for all new executives and senior leaders.

Enterprise Compliance held our first ever Compliance & Ethics Week, featuring an expert guest speaker and discussions about ethics in the workplace. In conjunction with the Compliance and Ethics Week, a survey was administered across the organization where over one thousand CalPERS team members participated. This provided valuable insight into team members' attitudes and perceptions about compliance and ethics. Based on the results, CalPERS was able to develop and implement a comprehensive communications, training, and education plan for FY 2016-17. To further expand the "Tone from the Top" initiative, Enterprise Compliance produced quarterly Inside CalPERS articles that are posted on CalPERS intranet featuring executives discussing topics on compliance and ethics.

To continue discussions about ethics and compliance, CalPERS developed a new Achieving CalPERS Excellence (ACE) award focusing on Compliance, Risk & Security champions. This internal award is intended to demonstrate CalPERS commitment to recognizing our team members' commitment to ensuring compliance, risk, and security awareness.

ENTERPRISE RISK MANAGEMENT

CalPERS 2017-22 Strategic Plan includes cultivating a risk intelligent organization as a primary goal. The following provides an overview of some key accomplishments and planned next steps as CalPERS continues to mature the Enterprise Risk Management Framework.

Internal Control Framework: Operational Risks Events

In June 2016, the Risk and Audit Committee approved the 2016-17 Enterprise Risk Management Plan to continue enhancing the Enterprise Risk Management Framework. In addition to establishing thresholds and KRIs, there is also an initiative to develop and implement an

operational risk event reporting process that will be carried over into the FY 2017-18 ERMD Plan.

The operational risk event reporting process was developed to identify and track potential internal control failures and trends across the enterprise and focus on identifying event triggers as well as mitigating and preventing internal control breakdowns. The reporting process will provide the enterprise with a systematic way to triage, correct, and monitor events discovered during “day to day” operations.

State Leadership Accountability Act (SLAA) (Formerly known as FISMA)

The California State Leadership Accountability Act (SLAA) requires state agencies to “maintain effective systems of internal control, to evaluate and monitor the effectiveness of these controls on an ongoing basis, and to biennially report on the adequacy of the agency's systems of internal control” (Cal. Gov. Code § 13400 et seq.). Effective June 24, 2015, SLAA was modified and updated through legislative action. The intent of the change is to provide the Department of Finance (DOF) with assurance that all levels of management are involved in evaluating, strengthening, and monitoring internal controls. SLAA requires each state agency to:

- Maintain effective systems of internal control
- Evaluate and monitor the effectiveness of these controls on an ongoing basis,
- Biannually report on the adequacy of the agency's systems of internal control

Biannual SLAA Corrective Action Plans were completed and timely filed with the DOF on December 31, 2016 and June 30, 2017.

Risk Awareness

CalPERS is committed to enhancing compliance and risk functions throughout the enterprise.

To cultivate a risk-intelligent organization, ERMD reaches out to inform stakeholders on how the Enterprise Management Framework is being used to manage the risks that CalPERS faces. Progress will be monitored and reported based on stakeholder survey results. Additionally, ERMD works with internal partners to train and educate CalPERS’ team members on the importance of risk management and personal accountability towards reporting risk.

THIRD LINE OF DEFENSE

Internal and external audits are the Third Line of Defense, offering an independent component to the levels of assurance provided by program areas and compliance and risk oversight functions.

OFFICE OF AUDIT SERVICES

In FY 2016-17, our Audit Services Public Agency Team completed compliance reviews of 29 agencies, census data testing reviews of 67 agencies, and special compensation reviews of 64 agencies. Audit Services uses business intelligence to perform the census data testing and special compensation reviews. As a result of the 160 reviews, 451 compliance issues were identified. Compliance reviews often identify misreporting prior to and after member retirement. The impact of misreporting could result in corrections to members' retirement benefits and increased workload to CalPERS in making those corrections.

As part of the review process, our Public Agency Team educated employers on the Public Employees' Retirement Law requirements and communicated the areas of noncompliance to CalPERS internal programs to assist them in identifying training needs for employers.

In FY 2016-17, our Internal Audit Team completed 27 internal audit assignments. These assignments included reviews of administrative expense management, our global equity program, death benefits, Health Care Decision Support System, Health Insurance Portability and Accountability Act (HIPAA) data assessment, health plan contract compliance, and external real estate manager contract compliance.

Additionally, Audit Services received the highest possible overall opinion, Generally Conforms, on our external quality assessment completed in December 2016 by the Department of Finance. The external quality review is required every five years by the International Standards for the Professional Practice of Internal Auditing.