

# Investment Compliance Program Annual Review

June 16, 2014

# Discussion Topics

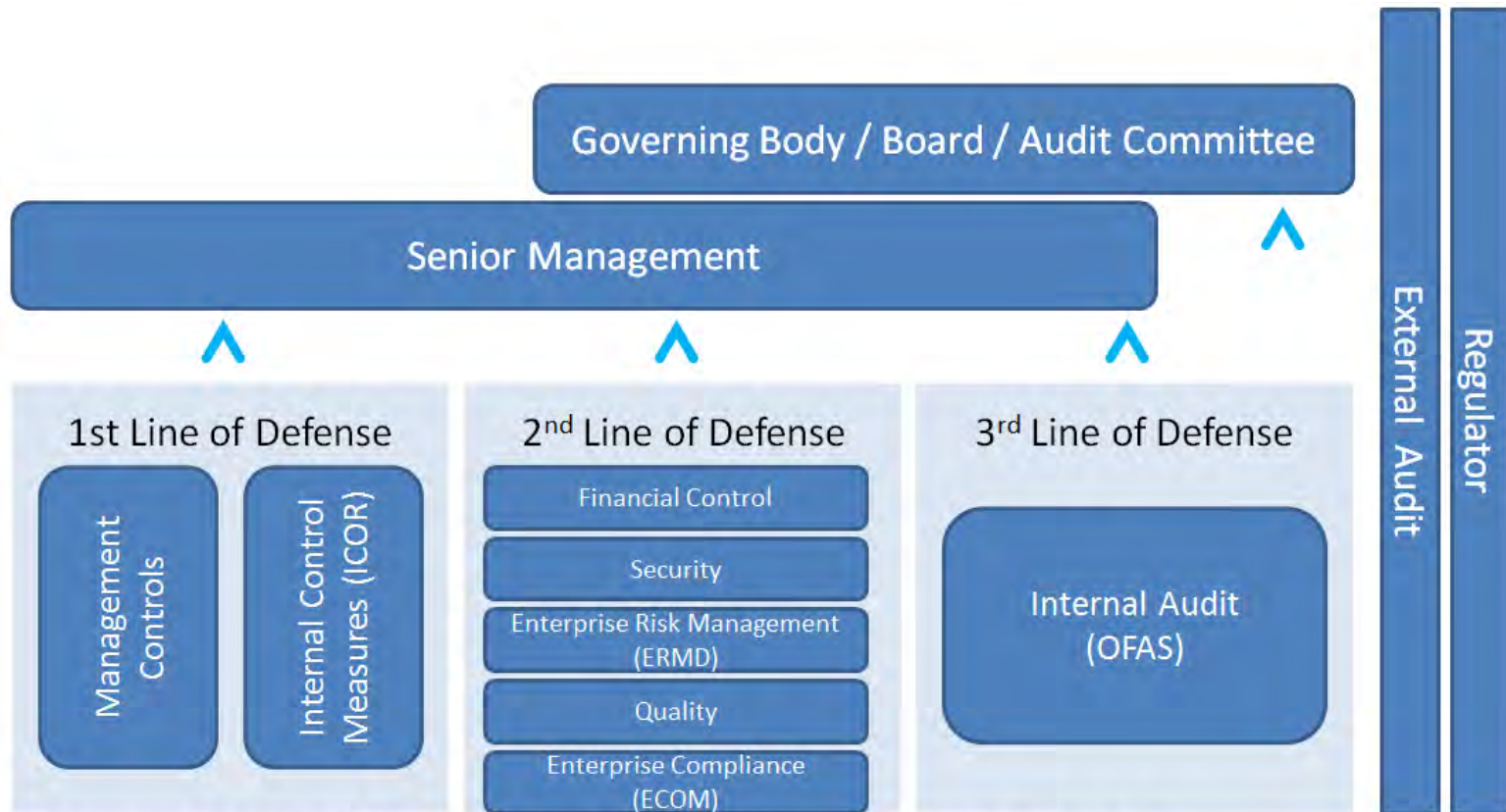
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# I. Investment Compliance Program Overview

## A. Program Background

# Cultivating a Risk Intelligent Organization through Effective Risk Management & Control

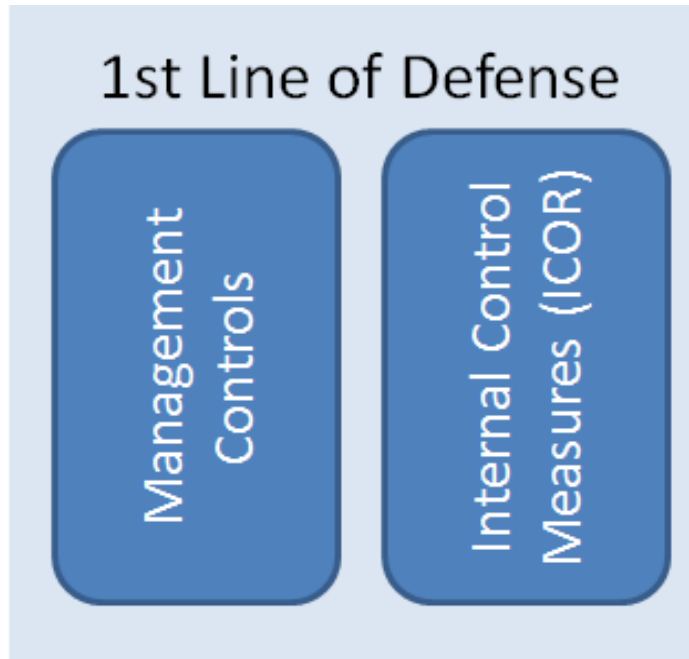
## The Three Lines of Defense Model



Adapted from ECIIA/FERMA *Guidance on 8<sup>th</sup> EU Company Law Directive, article 41*

# Program Background

First line of Defense – Investment Compliance Operational and Risk (ICOR)

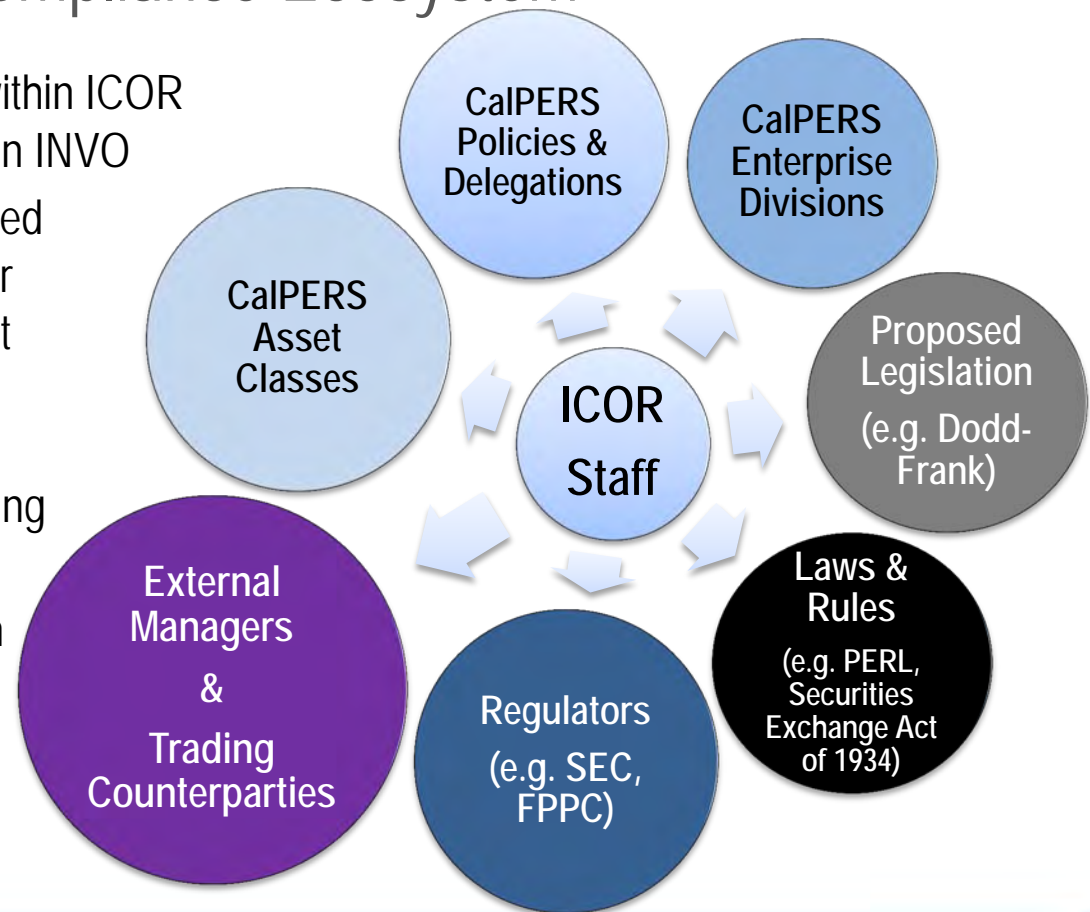


- Program modeled after best practices found at regulated external managers hired by CalPERS
  - Program ensures CalPERS Investment Office (INVO) maintains ongoing compliance with regulatory requirements
- ICOR promotes an organizational culture that seeks to eliminate or mitigate compliance risks
  - An effective compliance program benefits performance and CalPERS reputation

# Program Background (continued)

## CalPERS Investment Compliance Ecosystem

- Investment compliance functions within ICOR are performed by specialized staff in INVO
- ICOR staff are trained and developed to not only think in terms of whether what is being done is done right but also in terms of what additional policies, procedures, and internal controls are needed for strengthening INVO's culture of compliance
- The two senior leaders of this team collectively have over 52 years of work experience in regulated financial services with the majority focused on investment compliance



# Program Background

## Role of Investment Compliance

- ICOR Program modeled after best practices found at regulated external managers hired by CalPERS to manage investment capital
- External managers are generally required to register with the Securities and Exchange Commission (SEC) and must designate a chief compliance officer (CCO) to administer its compliance policies and procedures

*SEC's final rule requiring investment advisers to appoint a CCO states, "An [investment] adviser's chief compliance officer should be competent and knowledgeable regarding the [Investment] Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm."*



# Program Background (continued)

## Role of Investment Compliance (continued)

- CCOs must possess the following qualifications:
  - Backgrounds with investment advisory compliance related work experience
  - Knowledge and understanding of the Investment Advisers Act to be truly qualified
  - Appropriate authority; and
  - Sufficient amount of time to dedicate to the role
- Above factors will be considered by an examiner during a SEC regulatory exam
- Failure to appropriately staff investment compliance functions can result in SEC exam deficiencies, SEC enforcement actions, and penalties and fines for external managers
- External managers need to examine very closely whether they have adequate resources dedicated to investment compliance and whether they have the specialized staff to manage investment compliance program effectively



# Program Background (continued)

## What are the right questions for the Investment Committee to ask?

### Mutual Fund Company Board

- Do we have the right systems to ensure that observed compliance violations and compliance questions/concerns are surfaced and brought to the attention of appropriate personnel?
  - the Employee Hotline managed by Global Compliance
  - new culture of self-reporting violations
- Are we responding appropriately to identified compliance allegations and issues?
- Does senior management support the compliance program in terms of program needs?
  - the “Tone at the Top”
- Does the company have the right resources and personnel to oversee, manage and implement the program?
- Are the Board and Senior Management receiving the information they need to provide a reasonable degree of oversight of the compliance program?
- Has the board sufficiently documented its role in the compliance program and its level of commitment?

Source: January 2005 Global Compliance Report Presented by Carol Moody

### CalPERS Board of Administration

- What information about the risks facing the organization does the Board get to help it fulfill its stewardship and governance responsibilities?
- How do we know that the information the Board gets on risk management is accurate and reliable?
- What are our priorities as a Board in the oversight of risk management?
- How does the Board handle its responsibility for the oversight of opportunities and risks?
- How does the Board ensure that at least some of its members have the requisite knowledge and experience in risk?
- How do we, as a Board, help establish the “tone at the top” that reinforces the organization’s values and promotes a “risk aware culture”?
- How satisfied are we that the Board is doing what it should in overseeing risk?

Source: January 2014 CalPERS Board of Administration & Executive Offsite

# I. Investment Compliance Program Overview

## B. Alignment of ICOR Functions and Initiatives with Investment Beliefs Statements, INVO Roadmap Objectives and Target Operating Model (TOM)

# Alignment of ICOR Functions and Initiatives

## CalPERS Investment Beliefs Alignment

- Investment Beliefs Statements
  - CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution
  - Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error
- Role of ICOR in advancing Investment Beliefs Statements
  - ICOR processes involve managing compliance risk monitoring activities for investment policies, laws and regulations across asset classes
  - ICOR works with INVO Senior Staff to design and implement the operational processes and internal controls to ensure accountability of business objectives, compliance, and the management of risk
  - An effective investment compliance program supports the Investment Committee in its oversight capacity with regard to compliance with investment policies, the Investment Office risk assessment and providing an effective control environment

# Alignment of ICOR Functions and Initiatives (continued)

## INVO Roadmap: Strategic Priorities

	Objective	Core Issue	Actions Plan
Performance	Achieve our target rate of return without exposing the fund to undue risks	A challenging performance target and a need to resolve the ranking of returns relative to peers	<ul style="list-style-type: none"> <li>✓ Restructure legacy investments to improve risks, returns and cost effectiveness</li> <li>✓ Continue to identify and use cost/fee savings to self-fund increases in Plumbing and People</li> </ul>
Plumbing	Develop and implement the systems, controls, and processes necessary to assure the integrity of operations	Functional gaps in systems and controls create operational risks	✓ Implement the systems and controls (plumbing) needed to support the desired investment processes and strategies
People	Ensure that we have the right number of people with the right skills to enable investment performance improvement and control of operations	Complex portfolio management issues without the right mix of investment expertise	<ul style="list-style-type: none"> <li>✓ Restructure legacy investments to improve risks, returns and cost effectiveness</li> <li>✓ Continue to identify and use cost/fee savings to self-fund increases in Plumbing and People</li> </ul>

ICOR functions are key components supporting the Plumbing infrastructure. Architecting, testing and enhancing controls within the system assures maximum operability with appropriate checks and balances.

# Alignment of ICOR Functions and Initiatives (continued)

## Plumbing: TOM Refresh (March 2013)

- ICOR's strategic framework and core functions are driven from TOM and ICOR Roadmap
  - TOM Initiative #6: Investment Compliance Monitoring (Completed)
- ICOR is owner or co-owner of several INVO TOM initiatives identified as part of TOM Refresh
  - Vendor and Contract Compliance Management
  - Investment Proposal Tracking System
  - Business Continuity

# ICOR Roadmap Objectives

## Status Update

From:	To:	2013 Status	2014 Status
No inventory of key policies, laws and regulations that impact INVO	Ensure compliance with key policies, laws and regulations that impact the Investment Office	R	R
Lack of detailed and comprehensive compliance training for INVO staff	Ensure staff have full awareness and understanding of applicable policies, laws and regulations	G	G
Inconsistent documentation of compliance with key policies, laws and regulations	Ensure INVO staff retains adequate documentation to demonstrate compliance with key policies, laws and regulations	Y	Y
Lack of consistent monitoring of compliance with policies	End to end process for monitoring compliance with policies	Y	G

Overall Status
G = On Target
Y = Monitor
R = At Risk

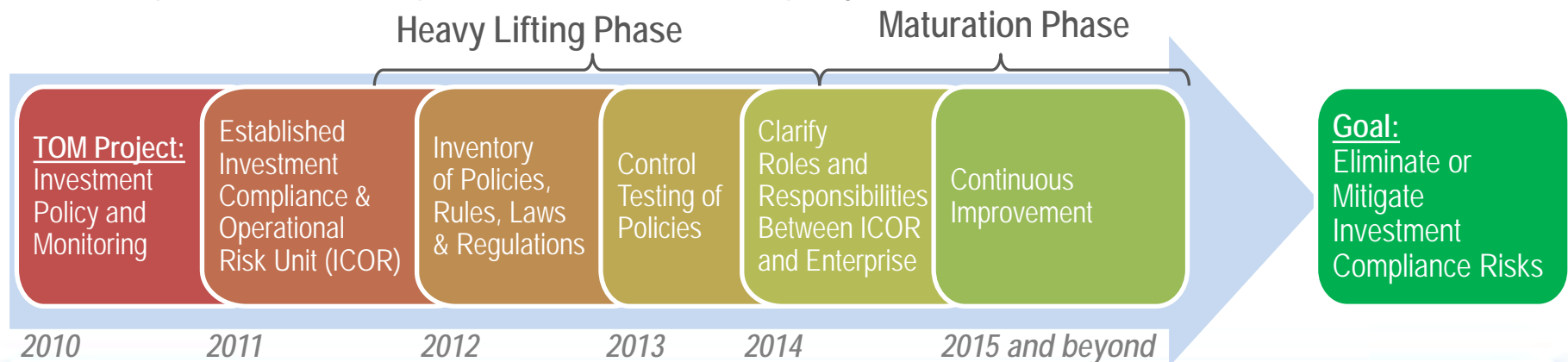
## II. Program Role & Scope



# Program Role

## Evolution of ICOR Program

- In 2010, INVO developed a Risk Heat Map and Target Operating Model (TOM)
  - Objective was to design, develop and implement a robust operating model that minimizes complexity, improves transparency and strengthens processes, systems and controls
  - The 2010 Risk Heat map and TOM initiative identified gaps in the INVO organization and a plan to address them
  - Investment Policy, Monitoring, Risk, and Governance Management were identified as high priorities and incorporated as INVO Roadmap objectives



# Program Role (continued)

## Program Development

- Heavy Lifting Phase (October 2011 to March 2014):
  - Establishing processes, conducting training programs and monitoring compliance with investment policies, laws and regulations, escalating breaches and recording resolutions
  - Phase completed except for inventory of laws and regulations that impact INVO
- Program Maturation Phase (March 2014 and beyond):
  - Evaluate that ethics and compliance efforts are progressing effectively with staff developing confidence in their abilities to manage and mitigate risks
  - Continuous improvement by institutionalizing completed initiatives, continually integrating industry best practices and changing regulatory environment, enhancing processes and systems on an ongoing basis
  - Evolve training programs as regulatory and INVO strategy changes occur

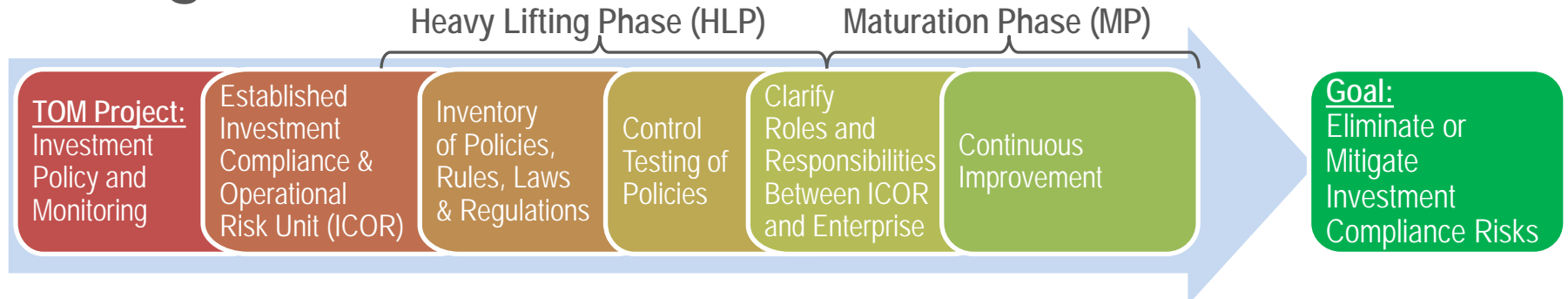
# Program Scope

## Operating Principles

- Compliance is an organization-wide responsibility that is fundamental
- Management of investment compliance risk is best accomplished through application of controls embedded into asset class practices and routines
- The program is built upon the working partnership between ICOR and INVO senior staff with input from several CalPERS divisions
  - Office of Enterprise Risk Management (OERM)
  - Enterprise Compliance Division (ECOM)
  - Legal Office (LEGO)
  - Office of Audit Services (OFAS)
- ICOR works with staff in fostering a proactive “getting compliance right the first time” approach
- Failure to manage investment compliance risk is often more costly (e.g., monetary losses, reputational risk, regulatory scrutiny) than not having a compliance function

## III. Program Structure & Responsibilities

# Program Structure – Functional



Development of ICOR Core Compliance Functions	CalPERS Division Interdependency	Phase
Daily portfolio investment compliance monitoring – Public Markets	INVO Asset Classes	MP
Maintenance of investment policies and procedures	INVO Asset Classes	MP
Annual and ongoing investment compliance training	HRSD / INVO Core Services	MP
Risk assessment of investment processes, policies, and procedures	OERM	MP
Periodic testing of investment policies and procedures	ECOM / OFAS	MP
Managing investment-related regulatory examinations	LEGO	MP

Heavy Lifting (HLP)

Maturation (MP)

# Program Structure – Functional (continued)

Development of ICOR Core Compliance Functions (Cont'd)	CalPERS Division Interdependency	Phase
Inventory of existing rules and regulations relevant to investment activities	ECOM / LEGO	<b>HLP</b>
Analysis and implementation of compliance control processes for new rules regulations relevant to investment activities (e.g., Dodd Frank)	INVO Asset Classes	<b>As Needed</b>
Identification and assessment of compliance risk for new and emerging investment-related initiatives (e.g., new security types)	INVO Asset Classes	<b>As Needed</b>

ICOR Non-core Compliance Support Functions	CalPERS Division Interdependency
Regulatory reporting/filing (e.g., Section 13 filings)	INVO Investment Servicing Division (ISD)
Employee investigations / Ethics Hotline incidents affecting investment staff	ECOM / LEGO / HRSD

Heavy Lifting (HLP)

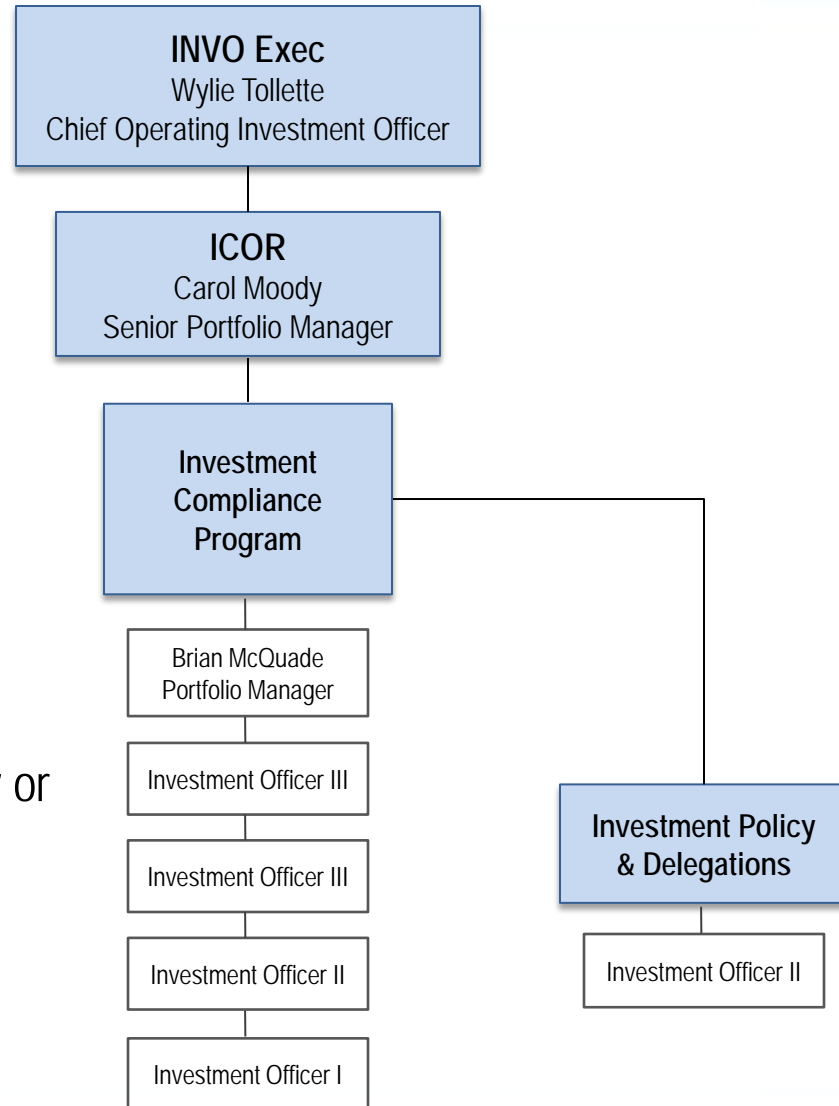
Maturation (MP)

# Program Structure – Organization Chart

## ICOR Total Staffing Resources\*

- Eighteen positions in total
- Nine positions dedicated to investment compliance program excluding temporary or part-time positions

\*As of June 1, 2014





# Program Responsibilities

## INVO Investment Compliance Program Shared Responsibility

### INVO Senior Staff:

- Develop and document appropriate procedures and processes
- Implement controls to prevent regulatory and policy violations
- Address control weaknesses through the automation of manual processes, use of technology, documenting procedures, training, etc.
- Meet regularly with ICOR staff to communicate changes in business plans

### ICOR Staff:

- Update program operating plan, procedures and inventory of policies and laws
- Provide periodic summary reporting to INVO senior management
- Conduct investment compliance reviews
- Provide investment compliance training
- Disseminate compliance related information to INVO staff
- Perform ongoing review of actual or potential conflicts of interest
- Address substantive regulatory requirements applicable to the business of INVO
- Conduct periodic self-assessment of the effectiveness of the ICOR Investment Compliance Program

# ICOR Core Function and Initiatives

## Accomplishments, Milestones and Hot Spots

### Risk Assessment

- Compliance risk assessment of processes, policies and procedures
  - ✓ Established compliance processes that follow defined protocols and industry practices
  - ✓ Developed minimum standard for compliance monitoring and oversight of external managers

### Testing & Reviews

- Instituted policy testing procedures
  - ✓ Completed testing high priority policies (2013)
  - ✓ Completed testing medium and low priority policies (2014)
- Milestone:
  - ✓ Confirmed performance of required control
- Preparing next testing cycle

### Policies & Procedures

- Completed new INVO policies: Records Retention and Trade Practices
- Co-developed new Investment Committee policy: Derivatives & Counterparty Risk
- Developed Operational Delegation of Authority (Non-investment related)
- Finalizing investment glossary of CalPERS-specific terms
- Standardize reporting frequency language in investment policies

# ICOR Core Function and Initiatives (continued)

## Accomplishments, Milestones and Hot Spots (continued)

### Control Environment

- Identify, report and remediate policy violations
  - ✓ Total Fund Monthly Update reporting of violations to Investment Committee
- Led Rapid Results Project to develop minimum standard for compliance monitoring and oversight of external managers

### Surveillance activities

- Daily portfolio compliance monitoring – Public Markets
- Private asset classes currently limited due to lack of technology resources
- CalPERS travel and gift policy compliance reviews

### Staff Training

- All INVO staff except those with approved absence, approximately 99+%, completed two hour in person training in 2013.
- Organizing 3rd annual investment compliance staff training scheduled for June 2014
- Organized INVO new employee onboarding training in November 2013, February 2014, and April 2014

### Policy Inventory & Records Mgt.

- Completed inventory of investment related policies owned and generated by Investment Committee
- Hot Spots:
  - ✓ Lacking inventory of state laws affecting INVO (other than PERL)
- Establishing automated solutions for storing investment-related business records that conforms with policy and legal requirements

## IV. Conclusions and Next Steps

# Conclusions & Next Steps

## Key Accomplishments and Upcoming Initiatives

2013-14 Key Accomplishments	2014-15 Initiatives
Investment compliance program is embedded into asset class practices	Mature program based on observations and best practices
Developed end-to-end process for monitoring compliance with policies complete for public market asset classes	Develop customized investment compliance program for private market asset classes
Tested controls for all investment committee approved policies	Recommend refinements to enhance control environment

# Appendix A

## Description of Core Functions

# Description of Core Functions

ICOR Core Investment Compliance Functions	Description
Compliance risk assessment	<p>The compliance risk assessment process is designed to consider, qualitative and measurable factors (e.g. historic regulatory fines) in determining the relative compliance risk associated with business processes in the scope of the INVO Compliance Program (the Program).</p> <ul style="list-style-type: none"> <li>• <u>Retrospective assessment</u> includes looking at the historic/current risk indicators (e.g. examination/audit findings) and existing facts and circumstances (e.g. recent significant change to a business process).</li> <li>• <u>Prospective assessment</u> includes considering the impact of INVO strategic direction and initiatives (e.g. increasing transaction levels), regulatory and industry trends, and trends identified in other key risk indicators.</li> </ul>
Internal and independent testing and reviews	<p>ICOR works with Asset Classes/Program Areas to develop schedule for performing compliance testing and validation procedures utilizing risk profile categories designed to represent the most common indicators of compliance risk related to the entities within the scope of the Program. Risk scores of 3 (high), 2 (medium), and 1 (low) are assigned to the risk profile categories based on an evaluation of key risk indicators. Compliance reviews focus on an assessment of the adequacy of compliance controls in place and verify the existence of specific compliance controls within INVO investment functions.</p>
Development and modification of policies and procedures	<p>New policies or modifications of existing ones can arise as circumstances dictate. Revisions will be made to the Program to ensure compliance with additional regulatory requirements, expansion of INVO activities, changes/amendments to applicable laws, rules and regulations, and any recommendations that come out of the testing effort. Summary results and recommendations are presented to the INVO Operating Committee.</p>



# Description of Core Functions (continued)

ICOR Core Investment Compliance Functions	Description
Ongoing recommendations to enhance control environment	<p>Controls can be in any format – policies, procedures, process maps, practices, daily routines, etc. However, the strength of the control(s) is usually directly correlated to the degree of formalization accorded the control, and the degree to which management reinforces (regularly communicates) the control. ICOR and Asset Classes/Program Areas regularly communicate changes in business plans that may affect compliance controls. ICOR obtains and comments on any formalized / written compliance controls, verifies that control procedures are being followed, identifies and immediately addresses any weaknesses discovered, and provides staff recommendations to maintain adequate compliance controls.</p>
Inventory and update relevant laws, rules and policies	<p>The INVO compliance inventory is the primary driver for much of ICOR's compliance review activities by serving as the primary guide for ICOR staff. It functions as:</p> <ul style="list-style-type: none"> <li>• An inventory of substantive regulatory requirements pertinent to INVO</li> <li>• A guide to overarching policies, guiding procedures and governing practices</li> <li>• A listing of business units accountable for performing routine operational functions associated with each regulatory requirement</li> <li>• A repository for the INVO Compliance Risk Assessment</li> </ul> <p>Compliance reviewers draw upon their experience and use the inventory to conduct compliance reviews – assess adequacy of policies and procedures, test compliance with specific regulatory requirements, and report findings and conclusions.</p>

# Description of Core Functions (continued)

ICOR Core Investment Compliance Functions	Description
Ongoing surveillance activities	<p>Oversight of compliance with public market asset classes is managed by ICOR. For example, ICOR monitors and manages the compliance process on a daily basis utilizing INVO Trade Order Management Systems. Rules based alerts and warnings are set up on each portfolio. In addition to the daily monitoring of compliance, other tasks include:</p> <ul style="list-style-type: none"> <li>• Reviewing and analyzing existing investment and delegation policies.</li> <li>• Reviewing and updating existing compliance rules.</li> <li>• Analyzing and creating new compliance rules.</li> <li>• Working with staff on compliance rule creation for policy and guideline rules for a new portfolio.</li> <li>• Administration of the CalPERS Restricted Company List process.</li> </ul>
Comprehensive ongoing and annual staff training	<p>ICOR organizes and provides staff training to educate employees on CalPERS policies and applicable laws, rules and regulations. Training sessions are provided during new employee onboarding seminars and thereafter during annual INVO Investment Compliance training sessions. Attendance at one of the annual investment compliance training sessions is mandatory for all INVO staff and failure to attend may negatively impact incentive compensation or performance ratings for management teams. Exceptions are granted only for staff who are on approved leaves of absence.</p>

# Appendix B

## 2013 and 2014 Annual Compliance Training Topics

# Program Structure – Functional

## Annual Investment Compliance Training Topics

### Covered Annually

- Form 700
- Personal Trading Regulations
- CalPERS Gift Policy
- CalPERS Restricted List Process

### 2013

- Approval of Outside Employment
- Post-Employment Restrictions
- Using the Ethics Helpline
- CalPERS Board Communication with Staff Guidelines
- Bagley Keene Open Meeting Act
- The Role of Stakeholders at CalPERS
- Undue Influence Policy

### 2014

- CalPERS Restricted Contact Policy
- Attorney Client Privilege
- Placement Agent Policy and Regulation
- Selected New INVO Policies
  - Records Retention
  - Derivatives and Counterparty Risk

