

THE REGENTS OF THE UNIVERSITY OF CALIFORNIA  
OFFICE OF ETHICS, COMPLIANCE AND AUDIT SERVICES



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Alexander Bustamante  
SENIOR VICE PRESIDENT  
CHIEF COMPLIANCE AND AUDIT OFFICER

June 10, 2020

**CHIEF INVESTMENT OFFICER BACHHER  
ACTING VICE PRESIDENT LLOYD  
DIRECTOR FERNANDEZ**

**RE: Final Report Project No. P20A007: Office of the Chief Investment Officer Annual Incentive Plan**

Attached is a copy of the final report for: Audit Services Project No. P20A007 Office of the Chief Investment Officer Annual Incentive Plan. With the issuance of this final report, please destroy any previous draft versions. We very much appreciate the assistance provided to us by you and members of your staff during our review. If you should have any questions please feel free to contact me at 510-987-9646 (email: [matthew.hicks@ucop.edu](mailto:matthew.hicks@ucop.edu)).

A handwritten signature in black ink, appearing to read "Matt Hicks".

Matt Hicks  
Systemwide Deputy Audit Officer

Attachment

cc: Senior Vice President Bustamante  
Chief Operating Officer Guimaraes  
Director Huang  
Systemwide Associate Audit Director Cataldo  
Contractor Harrigan

UNIVERSITY OF CALIFORNIA  
ETHICS, COMPLIANCE AND AUDIT SERVICES  
OFFICE OF THE PRESIDENT  
SYSTEMWIDE AUDIT

Senior Management Incentive Plans:  
Office of the Chief Investment Officer Annual Incentive Plan  
Audit No. P20A007  
April 2020

Work Performed by:  
Contract Auditor Harrigan

Work Reviewed by:  
Systemwide Associate Audit Director Cataldo  
Systemwide Deputy Audit Officer Hicks

## **Executive Summary**

### **Introduction**

As part of the University of California Office of the President (UCOP) 2019-20 fiscal year audit plan, Internal Audit completed a review of the Office of Chief Investment Officer (OCIO) Annual Incentive Plan (AIP or the Plan).

The purpose of the AIP is to provide a risk variable financial incentive to employees responsible for attaining key objectives in the OCIO. Participants may receive an annual incentive award based on investment performance and individual performance. The AIP Administrative Oversight Committee (AOC) approves participant performance objectives at the beginning of the Plan year. Eligible participants include senior management, professional investment and trading staff, and other key positions in the office as recommended by the Chief Investment Officer (CIO). Investment performance objectives are approved by the Regents' Investment Committee.

The AIP Administrative Guidelines (Guidelines) document serves to assist all involved parties in the application of the AIP provisions. The Guidelines may change from year to year to reflect AOC approved changes to the Plan or processes.

Annually, the Regents approve investment performance benchmarks for asset classes such as global equity, absolute return, liquidity, and others. State Street Bank is the fund custodian, and in addition to safekeeping and recordkeeping for all publicly traded assets, is responsible for calculating investment performance for all such portfolios, and for providing the investment returns of the several market indexes used as benchmarks. It also calculates and provides, for each performance objective, the difference between the portfolio and benchmark return, which is the basis of award calculations.

UC retained Mercer to recommend new investment performance standards for FY19. Once these were approved by the Regents, Mercer updated the AIP award calculation model taking into account changes in the investment component. The model will be updated as needed when the Plan or AIP Guidelines are updated.

UC Human Resources (HR) and the OCIO are the sources of additional input data such as participant names, salaries, performance measure weightings, and participant qualitative performance ratings, which are approved by the CIO. The model contains investment and participant performance measures and results (Threshold, Target, and Maximum levels). Investment performance data from State Street is input by the Office of the Chief Financial Officer (OCFO), and the remaining data is input by HR Compensation.

For investment officers and more senior positions, awards are payable in three annual payments comprised of 50 percent paid in the current Plan year, 25 percent paid in the next year and 25 percent paid in the year thereafter, plus accumulated interest from the Short-Term Investment Pool (STIP). Other participants receive 100% payout in the current year.

The AOC was established to provide oversight of Plan development, governance and interpretation. It is comprised of the Executive Vice President and Chief Operating Officer, the Executive Vice President and Chief Financial Officer, the Vice President - Human Resources, and the Executive Director – Compensation Programs and Strategy, which is currently a vacant position. Effective FY12, the AOC was also delegated authority by the Regents to approve non-material Plan changes, with material or substantive changes requiring the approval of the President and the Regents Governance Committee, and authority to review and approve participant performance objectives and award recommendations. Performance objectives and award recommendations for the CIO remain under the purview of the Board of Regents, thus requiring its approval. As of September 1, 2019, awards that place an incumbent's total cash compensation at or above \$323,700 are reported to the Regents via the Annual Report on Executive Compensation.

The AOC consults with the Senior Vice President and Chief Compliance and Audit Officer (CCAO) in an independent advisory capacity during its review of Plan participants' objectives and proposed awards. The CCAO assures that periodic auditing and monitoring occurs, as appropriate.

### **Objective and Scope**

The objective of the OCIO AIP audit was to assess the accuracy of FY19 award calculations and annual payouts (including deferred portions of awards) and verify compliance with the Plan. The following AIP award criteria were evaluated for accuracy and compliance: individual participant performance objectives, performance ratings, and payout calculations. In reference to performance ratings, we did not make a judgment on the performance and contribution towards goals. We accepted management's assurance that these were met.

We reviewed the FY19 award calculations and verified the eligible participants. For each participant, we verified the following:

- FY19 actual salary earnings
- AIP award opportunity percentages
- performance measure weightings
- subjective performance rating
- award opportunity
- pro-rated FY19 payout

We reviewed the FY19 payout calculations and verified the:

- initial award amounts for each participant (FY17, FY18, FY19),
- FY19 year one payout and FY17 and FY18 deferred award payouts for each participant, as applicable,
- spreadsheet formulas used for calculations for the FY19, FY18, and FY17 components of the payout calculation, including STIP allocations,
- quarterly accrued STIP amounts used in the payout calculations tied to the amounts listed in the general ledger, and

- payout amount for each participant included on the Payroll Payout Worksheet, prepared by the OCIO for the Payroll Office, agreed to the payout calculation.

As part of our audit, we also:

- verified that the FY19 participant qualitative objectives were approved by the AOC.
- reviewed the status of management's action plans from the prior reviews.
- performed an annual evaluation of investment performance results against source documents provided by State Street. We noted that OCIO decided to determine active allocation weights based on the monthly average approach rather than beginning of period average approach as used in previous years. An analysis was performed by Mercer for comparative purposes and the differences were determined to be immaterial. We verified these monthly averages to the final calculation model. No issues were noted. See Appendix A for further detail on the results of this review.
- verified that the changes made to the AIP, as reflected in the plan document and the Guidelines, were appropriately approved.
- performed a five-year trend analysis of participant awards and noted that the percentage of participants rated higher than meets expectations decreased in FY19 to 51% (20 participants) compared to 92% (28) in FY18, and 80% in FY17 (28). The FY19 percentage was lower than any other year in the previous five years.

### **Overall Conclusion**

During our audit, several participants received overpayments and four received underpayments as a result of data entry errors; some of these were added to the calculation model after it was initially reviewed by internal audit. Although overpayment and underpayment adjustments were subsequently processed, improvements in the change management and quality assurance processes are warranted. Additionally, the AIP Guidelines require updating and the current version of the Plan document should be posted at the start of each Plan year.

For a detailed discussion of these issues, including the management action plans, please refer to the subsequent pages of this report.

## Opportunities for Improvement and Action Plans

### 1. The change management and quality assurance processes related to the AIP award and payout calculations need improvement.

During our review, Internal Audit noted or was informed of several errors related to the calculation workbook and payouts as follows:

- a. After Internal Audit's initial review, changes were made to the calculation model intending to streamline calculations. As a result, several participants who had a 100% payout in a prior year incorrectly had a deferred amount and related STIP interest added to their payout calculations. These changes led to award overpayments to four participants totaling \$36,863 which were later corrected with subsequent pay adjustments. HR Compensation brought this to the attention of Internal Audit as fieldwork was still underway and we were able to confirm the accuracy of these final adjustments.

After being informed of this situation, Internal Audit reviewed the log and concluded that this change was not sufficiently documented as there was no indication of this change to the calculation workbook. This lack of documentation inhibits a second party from performing an effective quality assurance review.

- b. Mercer provided HR with updated performance standards for Total and Active Public (Global) Equity. Mercer erroneously highlighted these standards along with other relevant standards to indicate that they should be entered into the calculation model. However, only the Active Standard should have been highlighted by Mercer and entered into the model. As a result, FY19 incentive award payouts to four participants were underpaid by a total of \$20,730. This error was discovered after a Plan participant questioned their FY19 incentive award payment. Subsequent pay adjustments were made to correct the underpayments.
- c. HR informed us that while an OCFO staff person was entering FY19 participant data, it was discovered that one employee had a miscoded asset class in the previous award year (FY18) which resulted in overcompensation of \$17,145. The employee's current FY19 award payout was retroactively adjusted to compensate for this overpayment.
- d. Our review of the investment performance data inputs to the FY19 award calculation workbook identified several errors related to Private Equity and Public Equity performance objectives which were corrected prior to payouts to participants.

When planning the annual AIP process, time should be built in to allow for verification of all inputs and calculations by a second person prior to submitting the final award amounts to Internal Audit for review and before submitting to the

AOC for approval. This is especially necessary given the amount of manual data entry which increases the possibility of errors being introduced.

It is critical that any and all changes made to the calculation model be adequately documented and reviewed by an independent person to ensure the changes are reasonable and accurate. The change management review process should be enhanced to include documentation and approval requirements.

***Action Plans:***

*HR Executive Compensation, in consultation with the OCIO, will*

- a) Develop a comprehensive change management and quality assurance process that, at a minimum, includes a requirement that all changes are logged, including references to the relevant worksheet and cells that are changed.*
- b) Enhance and formally communicate the role of Mercer within the quality assurance process.*
- c) Ensure that review and testing by someone other than the party making the change is documented in detail in the change log.*

***Target date: June 30, 2020***

**2. AIP Guidelines and the AIP Plan documents require updating**

Our review noted that the AIP Guidelines and AIP Plan documents should be updated to reflect the following:

- Termination/separation provisions in Guidelines are not consistent with the AIP Plan document. The Guidelines state that for voluntary or involuntary termination, no deferred award payments or accrued interest will be due or paid after the date of separation. The Plan provides different payouts if separation is after the end of the Plan year.
- FY19 Guidelines included only prior year (FY18) investment performance objectives. The Guidelines should be updated annually to include performance objectives for the current Plan year.
- As of 1/29/20, only the FY18 AIP Plan document was posted on the UCOP website. By the beginning of the Plan year, the current year Plan document should be posted on the UCOP website.

***Action Plan:***

*HR Executive Compensation will update the Guidelines and Plan document for FY20 and post the approved FY20 AIP Plan document to the web site.*

***Target date:***

*Updates: June 30, 2020*

*Post AIP Plan document to the web site: Completed prior to issuance of this report.*

## Appendix A

### **Office of the Chief Investment Officer Annual Incentive Plan FY2018-2019 Investment Performance Review Results**

Pursuant to the University of California Office of the Chief Investment Officer (OCIO) Annual Incentive Plan, the Systemwide Vice President of Human Resources, requested the UCOP Office of Audit Services to review the investment data used to perform the OCIO Annual Incentive Plan (AIP) calculations. Accordingly, we obtained the investment benchmark data from the AIP Guidelines and verified they were accurately reflected in the calculation model.

In connection with the FY2018-2019 data provided by State Street Bank that was used in the AIP calculations, we performed the following:

- Obtained the actual performance data for the investments managed by the Treasurer's Office, from Human Resources - Compensation Programs & Strategy who received the data directly from the State Street Bank. The basis point differentials between actual performance and benchmarks provided on the spreadsheets were used in determining the incentive awards levels. We verified the calculations utilized the actual performance data, benchmark data and the basis point differentials from the State Street supporting spreadsheets.
- Confirmed that the basis point differentials were accurately transferred to the summary spreadsheets in the calculation model and to the "Benchmarks and Exhibit 2: Actual Fiscal Year 2018-2019 Performance Versus Annual Incentive Plan Performance Standards."