

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



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February 5, 2014

**EXECUTIVE VICE PRESIDENT BROSTROM**

**Subject: Final Audit Report Senior Management Incentive Plans: Office of the Chief Investment Officer Annual Incentive Plan– No. P14A008**

Attached please find a copy of the final report for Project No. P14A008 - Senior Management Incentive Plans: 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 (e-mail: [Matthew.Hicks@ucop.edu](mailto:Matthew.Hicks@ucop.edu))

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

Matthew Hicks  
Audit Director

Attachment

cc: Senior Vice President Vacca  
Chief Financial Officer Taylor  
Co-Acting Chief Investment Officer Stanton  
Co-Acting Chief Investment Officer Wedding  
Vice President Duckett  
Executive Director Larsen  
Director Yastishak  
Director Tierney  
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Consultant Carlson  
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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. P14A008  
November 2013

Work Performed by:  
Principal Auditor Wong  
Project Analyst Zorn  
Contract Auditor Harrigan

Work Reviewed by:  
Audit Manager Cataldo  
Audit Director Hicks

## **Executive Summary**

### **Introduction**

We have completed a review of the Office of Chief Investment Officer (CIO) 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 Office of the CIO. Participants may receive an annual incentive award based on investment performance and individual performance. Participant and investment performance objectives are approved by the AIP Administrative Oversight Committee (AOC) 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 CIO.

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.

UC has retained third parties to provide investment performance data (Cambridge Associates, State Street, and others). For the past two years, the Office of the Chief Financial Officer (OCFO) assisted in calculating the AIP awards. In prior years this was performed by a third party (Mercer).

UC Human Resources (HR) and Office of the CIO provide data to OCFO such as participant names, salaries, performance measure weightings, investment performance results, and participant qualitative performance ratings which are approved by the CIO. OCFO is responsible for updating the model, developed in Microsoft Excel, with Plan changes each year. The model contains investment and participant performance measures and results (Threshold, Target, and Maximum levels). OCFO calculates the annual awards and provides HR-Compensation the award amount for each participant based on the data provided.

For Investment Officer level or above, 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 on the Short-Term Investment Pool (STIP). These payout calculations are performed by Office of the CIO.

The AOC, comprised of the EVP – Business Operations, the EVP and Chief Financial Officer, the Vice President-Human Resources and the Executive Director – Compensation Programs and Strategy (CPS or HR Compensation), was established to provide oversight of plan development, governance and interpretation. 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 Committee on Compensation; and authority to review and approve participant performance objectives and award recommendations. Performance objectives and award recommendations for the CIO and Associate CIO remain under the purview of the Regents, thus requiring their approval. As of September 2011, awards that place an

incumbent's total cash compensation at or above \$250,000 are reported to the Regents via the Bi-Annual Compensation Report.

The AOC consults with the 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 CIO AIP incentive plan audit was to assess the accuracy of FY13 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 award and payout calculations. In addition, we assessed whether or not FY14 participant qualitative performance objectives cascaded between organizational levels. In reference to performance ratings, we did not make a judgment on the performance and contribution towards goals. We accepted management's assurance and documentation that these were met.

We tested 100% of participants' award calculations and verified the integrity of the FY13 award calculation model. We reviewed inputs, award calculation formulas and the mathematical curve used to determine actual award payouts for performance levels between threshold and maximum. The primary advantage of the curve is that it supports the achievement of consistent and sustained performance over the longer term by encouraging participants to achieve target level or higher performance.

We reviewed the FY13 payout calculation and verified:

- the initial award amounts for each participant (FY11, FY12, FY13),
- the FY13 year one payout and FY11 and FY12 deferred award payouts for each participant,
- the spreadsheet formulas used for calculations for the FY11, FY12, and FY13 components of the payout calculation, including short term interest (STIP) allocations,
- the quarterly accrued STIP amounts used in the payout calculations tied to the amounts provided by the budget office or contained on the approval memo from the CFO, and
- the amounts included on the Staff Recognition and Development Program Cash Payment form for each participant, prepared by Office of the CIO, agreed to the payout calculation.

We also followed up on management's action plans from the FY12 review.

As part of this review, we performed our annual evaluation of investment performance results against source documents provided by third parties such as State Street and Cambridge Associates. No issues were noted in this review. See Appendix A for further detail on the results of this review.

We verified there were no changes to the FY14 Plan and reviewed the revised Guidelines, effective for FY14.

### **Overall Conclusion**

Based on the information provided, we did not identify any errors in the calculations of the FY13 AIP award recommendations that were presented for approval to the AOC and the Regents Committee on Compensation. Also, we did not identify any errors in the final FY13 payout calculations (50% of current year award plus prior year deferred amounts and related STIP).

We reviewed the AOC approved revised Guidelines, effective for FY14 and noted compliance with Regental policy.

We observed that FY13 participant incentive performance goals/objectives were the same as, or cascade from the CIO's incentive goals and metrics but noted that the following management corrective action from the prior year audit was not completed:

- Employee start date will be added to the calculation spreadsheet so that OCFO can verify the "time in position" and weightings as part of its review. Target Date: August 1, 2013

Additionally, we observed that an error noted in last year's payout calculation workbook was carried forward into this year's workbook and was therefore noted again as an error (see observation #2 on page 5). This error would have resulted in an overpayment if left uncorrected.

We also noted the following new opportunities for improvement:

- Errors were noted by Internal Audit during the initial review of calculation model input data. While these were corrected by Office of the CIO and resubmitted, it indicates a need for additional quality review.
- There are inconsistencies between current practice and documentation related to the Plan (Regents policy, AIP, Guidelines). See Appendix B.

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

### ***Management Actions***

*Management has provided Action Plans that will address the issues identified in the report and as detailed in the Opportunities for Improvement.*

# Opportunities for Improvement and Action Plans

## 1. Errors were identified in the award calculation for five employees.

The errors identified by Internal Audit below were corrected by Office of the CIO or CFO in a timely manner and in advance of payout. However, it indicates that additional quality review is warranted.

In reviewing inputs to the calculation model, we noted the following:

- Due to an incorrect weighting, a new employee had a performance rating of “Meets Expectations” (100% award) but the employee’s individual qualitative award was calculated at the “Far Exceeds Expectations” (200% award) amount. This would have resulted in an award of \$23,694 instead of the correct amount of \$11,847- an overpayment of \$11,857.
- Four Directors had incorrect Performance Measure weightings. Each had the weightings for a Managing Director of 40% entity, 50% Asset Class/Functional Group/Sector instead of the correct weightings of 30% and 60% respectively.

Left uncorrected, these errors would have resulted in incorrect award amounts for these participants.

### **Action Plan:**

*The Office of the CIO and OCFO will work together to enhance the review process and determine which cells can be write protected to reduce the possibility of errors.*

### **Target date:**

*August 1, 2014*

## 2. One participant’s payout calculation was incorrect.

The error below was identified by Internal Audit and corrected in a timely manner, in advance of payout, but it indicates a need for additional quality review.

A deferred award amount was inappropriately included in a participant’s payout calculation in the current year. The employee’s position is below Investment Officer level so 100% of the award is to be paid out in the current year (with no deferred portion). This error was corrected prior to payout. This error was noted last year and the payout workbook was not corrected to indicate that this participant did not have any deferred award amounts.

Left uncorrected, this would have resulted in an overpayment of \$3,995.03 to the participant.

### **Action Plan:**

*The Office of the CIO and OCFO will work together to enhance the review process.*

### **Target date:**

*August 1, 2014*

### **3. Variances exist between Policy, AIP, Guidelines and current practices.**

We noted a number of variances between current practice and/or Policy or Guidelines. Inconsistencies are present in the following areas:

- Award percent (base salary vs. actual salary)
- Approval authority
- Approval timing
- Performance standards
- ACO signoffs

These variances were provided to HR Compensation and are detailed in Appendix B.

***Action Plan:***

*Compensation Programs and Strategy (CPS) and the CIO will discuss practices that vary from the Plan to determine if some or all should result in a request that the AOC approve changes to the Plan and possibly to Regental policy.*

***Target date:***

*June 30, 2014*

## Appendix A

### **Treasurer's Annual Incentive Plan 2012-13 Investment Performance Review Results**

Pursuant to the University of California Office of the Treasurer Annual Incentive Plan, the Executive Director, Compensation Programs and Strategy asked the Office of Audit Services to review the data used to perform the Treasurer's Office Annual Incentive Plan (AIP) calculations. For fiscal year 2012-2013, we requested State Street Bank's summary and supporting spreadsheets and Cambridge Associates data on private equity assets.

In connection with the data used in the AIP calculations provided by State Street Bank, we performed the following:

- Obtained the actual performance and benchmark data for the investments managed by the Treasurer's Office, from Human Resources - Compensation Programs & Strategy who had 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.
- Obtained Private Equity data from the Human Resources - Compensation Programs and Strategy, who received the data from Cambridge Associates. We traced these results to the summary spreadsheets used as the basis for the AIP calculations.
- Confirmed that the basis point differentials were accurately transferred to the summary spreadsheets (Input 2: Actual Fiscal Year 2012-2013 Performance Versus Annual Incentive Plan Performance Standards).

Based on this review, we did not identify any deficiencies or errors in the 2012-2013 spreadsheets that would lead us to believe that the basis point differentials used in determining AIP calculations were incorrect or inaccurate.



Appendix B

**Treasurer's Annual Incentive Plan  
Analysis of Current Practices compared to Policy, Plan and Guidelines**

<b>Topic</b>	<b>Regents Policy 7712</b>	<b>FY13 AIP</b>	<b>FY13 AIP Guidelines</b>	<b>FY13 Practice</b>
Roles: President Regents Chairs		"Prior to the beginning of the Plan year, the AOC will provide the <b>President and Chairs of the Regents' Committees on Compensation and Investments with a list of Plan participants</b> " (p 2).	"On an annual basis, the AOC will review and approve the following:... Participants for the following Plan year..." (p 1) <b>No mention of President &amp; Chairs.</b> Guidelines include descriptions of "Roles", but there aren't any defined for the President & Chairs of Regents committees.	<b>Variance between Plan and Guidelines.</b>
AOC signoffs			"All approvals and changes made by the AOC will be documented on an AOC Approval Form and <b>signed and dated by each member of the AOC</b> " (p 1)	<b>Variance between Guidelines and Practice.</b> For the June 2013 meeting, <b>AOC sign-off was by Chair only.</b> For the August 2013 meeting, all members signed off.
Salary: base vs. earned		"Newly hired participants will receive a prorated award in the first year based on the <b>actual salary received...</b> " (p 2)	Award is a percent of " <b>base salary</b> " p 5 vs. p 7 "The participant's <b>actual salary received...</b> will be used in the calculation of the award payout" (p 3-4) "The CPS Group compiles <b>salaries paid</b> which are used as the basis for award calculations"	<b>Variance between Plan and Guidelines.</b> Practice is to use <b>earned salary</b> (unless prorated due to transfer within Treasury/UC)
Award Opportunity Levels	III.A. Plan Document" ... The Plan document will include the following elements: ... Award opportunity levels (e.g., <b>threshold, target and maximum</b> ), when appropriate ..." (p 2-3).	"Each performance objective will include standards of performance defined as follows: Threshold... Target... Maximum" (p 4)		<b>Variance between Plan and Practice.</b> None of the participant subjective/qualitative objectives include standards of performance (Target, Threshold, Max).

Topic	Regents Policy 7712	13-14 AIP	13-14 AIP Guidelines	FY13 Practice
Approval Authority: HR vs. OCIO	<p><b>IV. APPROVAL AUTHORITY</b></p> <p><b>IV. A. Implementation of the Policy</b></p> <p>“The Vice President—Human Resources is the Responsible Officer for this policy and has the authority to implement the policy. The Responsible Officer may apply appropriate interpretations to clarify policy provided that the interpretations do not result in substantive changes to the underlying policy.” (p 5)</p>	13-14 AIP	<p>Administrative roles - Role of the OCIO</p> <p>“The OCIO is responsible for the general interpretation and implementation of the Plan.” (p 2)</p>	<p><b>Variance between Regents Policy and Guidelines.</b></p>
AOC approvals	<p>“III.C. The AOC will review and approve plan participants’ performance objectives prior to the start of the plan year.” (p 4)</p>	<p>“Individual/Qualitative performance objectives for each ... participant ... will be subject to endorsement by the CIO and approval by the AOC in consultation with the President and Chairs of the Regents committees on Compensation and Investments prior to the beginning of the Plan year.”(p 4)</p>	<p>“Individual Subjective performance objectives for each Plan participant...will be approved by the CIO and AOC prior to the beginning of the Plan year.” (p 8)</p>	<p><b>Variance between Policy and Practice.</b></p> <p>AOC reviewed and approved Sr. Management participant objectives, not all participant objectives, prior to the start of the FY14 plan year. Other participant objectives were approved in August 2013.</p>
Transfer from one asset class to another		<p>“In special cases, such as for a new participant charged with the restructuring of an entire asset class or strategy, the ... weights may be modified at the recommendation of the CIO, subject to approval by the AOC.” (p 5)</p>	<p>“Beginning with FY2013-2014, participants who transfer from one existing asset class to another are evaluated using the same methodology as is used for new participants...increased Individual/Qualitative weighting in the first two years” (p 7)</p> <p>(Note: Guidelines are approved by the AOC)</p>	<p><b>Variance between Policy and Guidelines.</b></p>