

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



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John A Lohse
INTERIM SENIOR VICE PRESIDENT
CHIEF COMPLIANCE AND AUDIT OFFICER

March 6, 2017

**CHIEF INVESTMENT OFFICER BACHHER
EXECUTIVE DIRECTOR LARSEN**

RE: Final Report Project No. P17A007: OCIO Annual Incentive Plan

Attached is a copy of the final report for: Audit Services Project No. P17A007 OCIO 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).

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

Matt Hicks
Systemwide Deputy Audit Officer

Attachment

cc: Interim Senior Vice President Lohse
Associate Chief Investment Officer Guimaraes
Director Huang
Director Fernandez
Manager Cataldo
Data Manager Zorn
Principal Auditor Wong
Senior Analyst Ardeshir

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. P17A007
February 2017

Work Performed by:
Principal Auditor Wong
Data Manager Zorn

Work Reviewed by:
Systemwide Audit Manager Cataldo
Systemwide Deputy Audit Officer Hicks

Executive Summary

Introduction

We have 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. 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 Chief Investment Officer (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 and State Street Investment Analytics). For the past five 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).

Human Resources (HR) and the OCIO provide data to the OCFO such as participant names, salaries, performance measure weightings, investment performance results, and participant qualitative performance ratings which are approved by the CIO. The OCFO updates 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). The OCFO typically calculates the annual awards and provides HR-Compensation the award amount for each participant based on the data provided. A mathematical curve is used to determine actual award payouts for performance levels between threshold and maximum levels. 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.

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 from the Short-Term Investment Pool (STIP). The OCFO's Business Resource Center (BRC) enters the quarterly STIP interest amounts in the payout workbook and then OCIO calculates participant payouts for the current year.

The AOC, 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 (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.

The AOC consults with the Senior Vice President 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 incentive plan audit was to assess the accuracy of FY16 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 reference to performance ratings, we did not make a judgment on the performance and contribution towards goals as we accepted management's assurance and documentation that these ratings accurately reflected the individual's performance and contribution.

We tested 100% of participants' award calculations and verified the integrity of the FY16 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 levels.

We reviewed the FY16 payout calculation and verified:

- the initial award amounts for each participant (FY14, FY15, FY16) were accurate,
- the FY16 year one payout and FY14 and FY15 deferred award payouts for each participant were accurate,
- the spreadsheet formulas used for calculations for the FY14, FY15 and FY16 components of the payout calculation, including STIP allocations, were accurate,
- the quarterly accrued STIP amounts used in the payout calculations tied to the amounts provided by the Business Resource Center and listed in the general ledger, and
- the payout amount for each participant included on the Payroll Payout Worksheet, prepared by the OCIO for the Payroll Office, agreed to the payout calculation.

We reviewed the FY17 participant qualitative objectives and confirmed they were approved in advance of the prior fiscal year-end, as required by the Plan. We also followed up on management's action plans from prior audits.

We also 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 evaluation. See Appendix A for further detail on the results of this review.

We verified there were no changes to the Plan other than to amend the date to reflect the plan year. We noted there were some minor changes to the Guidelines compared to the prior year and these changes were approved by the AOC.

Overall Conclusion

Based on the information provided, we did not identify any errors in the calculations of the FY16 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 FY16 payout calculations (50% of current year award plus prior year deferred amounts and related STIP for Investment Officer level and above).

We reviewed the AIP award calculations produced by the HR, OCIO, and OCFO and identified several data input errors and discrepancies. HR, OCIO and OCFO promptly resolved all errors and discrepancies prior to AOC approval and payout. Accordingly, we noted an opportunity of improvement for the HR, OCIO, and OCFO related to implementing an internal review process that incorporates a timely quality assurance to enhance data input accuracy.

Regarding management corrective action from prior audits, we noted the following:

- In a prior year audit, we noted that payroll provided inaccurate or incomplete earnings for several participants. The resulting management corrective action identified that HR Compensation will document the required format and content of the participant payroll data required and request that the UCPATH team provide a report. Target Date: August 1st, 2016. HR-Compensation is currently working to complete this management corrective action.

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

Opportunities for Improvement and Action Plans

1. HR, OCIO and OCFO will develop a review procedure to enhance data input accuracy.

During our review, we noted that there were several data input errors and discrepancies on payroll, investment performance, and payout calculations. HR, OCIO and OCFO promptly resolved all errors and discrepancies prior to AOC approval and payout. Although the errors and discrepancies were cleared and the payout request was corrected before finalization, HR, OCIO, and OCFO would benefit from implementing an internal review process that incorporates a timely independent quality assurance review to enhance the data input processes.

Management Corrective Action Plan: HR, OCIO and OCFO will amend the AIP calculation processes to include an independent quality assurance review to enhance completeness and accuracy of data input.

Target date:

June 30, 2017

Appendix A

Office of the Chief Investment Officer Annual Incentive Plan 2015-16 Investment Performance Review Results

Pursuant to the University of California Office of the Chief Investment Officer (OCIO) Annual Incentive Plan, the Executive Director, Compensation Programs and Strategy asked the Office of Audit Services to review the data used to perform the OCIO Annual Incentive Plan (AIP) calculations. For fiscal year 2015-2016, 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 (Benchmarks and Input 2: Actual Fiscal Year 2015-2016 Performance Versus Annual Incentive Plan Performance Standards).

Based on this review, we did not identify any deficiencies or errors in the final version of the 2015-2016 spreadsheets that would lead us to believe that the basis point differentials used in determining AIP calculations were incorrect or inaccurate.