

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

March 18, 2022

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

RE: Final Report Project No. P22A003: Senior Management Incentive Plans: Office of the Chief Investment Officer Annual Incentive Plan

Attached is a copy of the final report for: Audit Services Project No. P22A003 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 (email: 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
Executive Vice President Brostrom
Executive Vice President Nava
Chief Operating Officer Guimaraes
Director Huang
Systemwide Associate Audit Director Bishin
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. P22A003
February 2022

Work Performed by:
Contract Auditor Harrigan

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

Executive Summary

Introduction

As part of the University of California Office of the President (UCOP) 2021-22 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 Investments 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 FY 2020-21. 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 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 Compensation Programs & Strategy (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 interest. Beginning with the current year awards, interest is based on the three-year average of Global Equity returns. 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. 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. The AOC was also given 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, 2020, awards that place an incumbent's total cash compensation at or above \$340,000 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 primary objectives of the OCIO AIP audit were to assess the accuracy of FY 2020-21 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 FY 2020-21 award calculations and verified the eligible participants. For each participant, we verified the following:

- FY 2020-21 actual salary earnings
- AIP award opportunity percentages
- performance measure weightings
- subjective performance rating
- award opportunity

We reviewed the FY 2020-21 payout calculations and verified the:

- initial award amounts for each participant (FY 2018-19, FY 2019-20, FY 2020-21),
- FY 2020-21 year one payout and FY 2018-19 and FY 2019-20 deferred award payouts for each participant, as applicable,
- spreadsheet formulas used for calculations for the FY 2020-21, FY 2018-19, FY 2019-20, components of the payout calculation, including interest allocations,
- interest 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 FY 2021-22 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 verified these monthly averages to the final calculation model. See Appendix A for further details on the results of this review.
- verified that any 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 FY 2020-21 to 59% (23 participants) compared 61% (27 participants) in FY 2019-20 and 51% (20 participants) in FY 2018-19.

Overall Conclusion

Based on the information provided, we did not identify any errors in the calculations of the FY 2020-21 AIP award recommendations that were presented for approval to the AOC and the Regents Governance Committee. Also, we did not identify any errors in the final FY 2020-21 payout calculations (50% of current year award plus prior year deferred amounts and related interest for Investment Officer level and above).

We noted the following opportunities for improvement:

- **Data Variances**
There were minor variances between the data provided by State Street and the award calculation model.
- **Timeliness**
 - FY 2021-22 Investment performance standards (objectives) were not approved by the AOC until December 2021. Also, the FY 2021-22 AIP Guidelines document could not be updated until after AOC approval.
 - The AOC did not receive or approve any FY 2021-22 participant objectives until November, 2021.
 - The FY 2021-2022 plan document was not posted to the UCOP web site until November, 2021.

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. There were variances between some of the investment performance data items.

We noted minor variances between some of the data provided by State Street and the award calculation model. This is reported in Appendix A – FY 2020-21 Investment Performance Review Results. The OCIO and the OCFO followed up with State Street and were informed that the last 3 months of Fiscal Year 2020 fixed income weights were not updated in time by State Street. This Fixed Income benchmark is used for AIP purposes only and does not impact other reporting. Additionally, there was no impact to participant payout. However, this indicates a need for improved communications from State Street.

***Action Plan:** HR Executive Compensation will consult with OCFO, and State Street, as needed, regarding improving State Street’s communications if they make changes to investment performance benchmarks or other investment data. If State Street has changes going forward, HR will ensure they are documented in the calculation model change log.*

***Target date:**
March 31, 2022*

2. Documents were not approved or posted on a timely basis.

a. The AOC did not approve the FY 2021-22 participant or investment performance objectives timely.

The FY 2021-22 investment performance objectives were not approved by the AOC until December 2021 and the participant objectives were not approved until October 15, 2021. Per the Plan, “Individual/Qualitative performance objectives for each Plan participant ...will be subject to ...approval by the AOC prior to the beginning of the Plan year or as soon as possible thereafter.”

As awards are based on fiscal year performance against objectives, if objectives are not approved timely, participants may remain uncertain regarding performance expectations and related award achievement levels. Also, due to the outstanding investment objectives, HR Compensation could not update the FY 2021-22 AIP Guidelines document timely.

b. The AIP Plan document was not posted to the web site timely.

The FY 2021-22 AIP Plan document was not posted on the UCOP website until November 2021. By the beginning of each Plan year, July 1, the current year Plan document should be posted. For transparency purposes, the current Plan should be available for participants and interested parties to review.

Action Plan:

In consultation with OCIO, HR Executive Compensation finalized the schedule for FY 2021-22 and FY 2022-23 AIP related activities to facilitate approval of the plan document, participants and objectives for the 2022-23 plan year and the approval of awards for the 2021-22 plan year. This schedule will enable HR Exec Comp to provide the approved plan document to ECAS no later than June 15th for publication on the UC website.

Key updates to the schedule:

- At OCIO AIP meeting in May 2022 (currently scheduled for 5/25/22), approve 2022-23 plan document, participants, and qualitative objectives; send approved plan document to ECAS after approval*
- At OCIO AIP meeting in June 2022 (currently scheduled for 6/22/22), approve 2022-23 performance standards as submitted by Mercer Consulting*
- For 2021-22 awards, HR and OCFO will complete inputs to the FY 2021-22 calculation model by 7/15/22 and submit worksheet to Mercer for final review and to ECAS for audit purposes.*
- At OCIO AIP meeting in August 2022 (currently scheduled for 8/24/22), approve 2021-22 awards*
- At September 2022 Regents meeting, seek approval of award for VP/CIO Bachher, after which awards for all participants will be released on/before 10/5/22.*

Timeline for OCIO AIP meetings:

Office of the Chief Investment Officer Administrative Incentive Plan (OCIO-AIP) - AOC Meetings	Meeting Date/Time
<i>AOC Meeting (If needed): Discuss/Finalize 2022-23 changes that require Pres/Regental approval (May Governance/Full Board)</i>	<i>Wed. 3/30/2022 2:15pm</i>
<i>AOC Meeting/Ballot: 2022-23 Plan Document, Participant List, and Qualitative Objectives</i>	<i>Wed. 5/25/2022 10am</i>
<i>AOC Meeting: 2022-23 Performance Standards from Mercer</i>	<i>Wed. 6/22/2022 10am</i>
<i>AOC Meeting: 2021-22 VP-CIO Award for presentation to President then Governance/Full Board at September meeting; 2021-22 results/awards for all other participants (For payout between 9/25/22 - 10/5/22)</i>	<i>Wed. 8/24/2022 10am</i>

Target date:

Completed prior to issuance of the audit report.

Appendix A

Office of the Chief Investment Officer Annual Incentive Plan FY 2020-21 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 and the investment performance results and verified they were accurately reflected in the calculation model, with some exceptions related to the benchmarks.

In connection with the FY 2020-21 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 Office of the Chief Investment Officer, 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 noted minor variances between some of the data provided by State Street and the award calculation model. The OCIO and the OCFO followed up with State Street and were informed that the last 3 months of Fiscal Year 2020 fixed income weights were not updated in time by State Street. This Fixed Income benchmark is used for AIP purposes only and does not impact other reporting. Additionally, there was no impact to participant payout.

- 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 2020-2021 Performance Versus Annual Incentive Plan Performance Standards.”