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

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Sheryl Vacca
SENIOR VICE PRESIDENT
CHIEF COMPLIANCE AND AUDIT OFFICER

February 5, 2016

CHIEF INVESTMENT OFFICER BACHHER
EXECUTIVE DIRECTOR LARSEN

RE: Final Report Project No. P16A007: OCIO Annual Incentive Plan

Attached is a copy of the final report for: Project No. P16A007 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).

Matt Hicks
Systemwide Deputy Audit Officer

Attachment

cc: Senior Vice President Vacca
Associate Chief Investment Officer Guimares
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Finance Officer Squires
Contractor Harrigan
Data Manager Zorn

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. P16A007
October 2015

Work Performed by:
Contract Auditor Harrigan
Principal Auditor Wong
Data Manager Zorn

Work Reviewed by:
Audit Manager Cataldo
Audit Director 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 four 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 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. One objective is for the OCFO to update 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 typically 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 from the Short-Term Investment Pool (STIP). OCFO's Business Resource Center (BRC) enters the quarterly short term investment pool (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. As of September 2014, awards that place an incumbent's total cash

compensation at or above $301,000 are reported to the Regents via the Annual Report on Executive Compensation.

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 FY15 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. 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 FY15 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 FY15 payout calculation and verified:

- the initial award amounts for each participant (FY13, FY14, FY15),
- the FY15 year one payout and FY13 and FY14 deferred award payouts for each participant,
- the spreadsheet formulas used for calculations for the FY13, FY14 and FY15 components of the payout calculation, including STIP allocations,
- the quarterly accrued STIP amounts used in the payout calculations tied to the amounts provided by the Budget Office 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 FY16 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.

Finally, 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 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 FY15 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 FY15 payout calculations (50% of current year award plus prior year deferred amounts and related STIP for Investment Officer level and above).

We noted the following opportunities for improvement:

- Payroll provided inaccurate or incomplete earnings for several participants.
- The AIP award calculation process is a manual and complex process. The past few years, there has been significant turnover in personnel involved in the award and payout calculation processes. This year, there will be a retirement. Documentation of the process and procedures regarding AIP would improve the process, reduce input errors, and ensure continuity when there is turnover. The lack of documented repeatable processes contributed to several discrepancies and data input errors that were noted by audit during field work. It should be noted that both OCIO and OCFO worked together and promptly resolved the issues prior to AOC approval and payout.

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

- In FY14, we noted no FY15 participant objectives had been approved in advance of the plan year, as required by the plan. The management corrective action was to provide these to the AOC for review and approval by February 2015. They were not provided until June 2015. As a result, two employees who retired in prior months received FY15 awards but did not have any approved performance objectives. It was explained that the reason for the significant delay was that the OCIO needed to finalize their reorganization, personnel changes, and changes in investment approach before objectives could be finalized. This was discussed with the AOC members prior to receiving their approval of the objectives.
- In FY13, we noted inconsistencies between current practice and documentation related to the Plan (Regents policy, AIP, Guidelines).
  Target Date: June 30, 2014
  Per discussion with HR-Compensation and the CIO, any AIP changes will need to be submitted to and approved by the Regents. See Appendix B for the discrepancies noted in the FY13 audit.

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. Payroll provided inaccurate or incomplete earnings for several participants.

HR Compensation requested participant earnings from July 1, 2014-June 30, 2015 from Payroll, to determine actual earnings for the AIP-eligible population. After reviewing the original version, HR Compensation questioned some of the amounts. Payroll provided an updated version, but only corrected some of the incumbents' records, not all. After discovering that only employees with partial years of service had been corrected, HR Compensation requested Payroll to send a new report with all earnings data corrected, and asked Audit to review the data.

Audit completed a review and noted several errors. For example, Payroll indicated that none of the employees had terminal vacation pay (TVP), when in fact three employees did. When HR Compensation asked Payroll to verify the amount of TVP earned, Payroll provided the number of hours instead of the dollar amount. The situation resulted in unnecessary time and effort spent in resolving the problems, and raised questions regarding the integrity of the data provided by Payroll.

These issues were resolved internally and prior to AOC approval and award payments.

Action Plan:
After the audit, the UCPath payroll system was implemented for UCOP. As part of this implementation, core payroll processing services for UCOP transitioned from the BRC to the UCPath Center in Riverside. For FY16 award calculations, HR Compensation will document the required format and content of the participant payroll data required and request that the UCPath team provide a report. Once the report is received, HR Compensation will consult with Audit to determine if additional independent verification is necessary and possible, given system access levels.

Target date:
August 1, 2016

2. There are no documented procedures for reference by OCFO or OCIO for AIP award calculation.

Over the past several years, there has been significant turnover in the AIP contact at both OCFO and OCIO. This year, we identified errors in the investment performance data, performance measure weightings, and the final payout amounts for four retired or terminated employees. These errors were corrected internally and in a timely fashion by the OCIO or OCFO and in advance of AOC/Regents approval and payout. If the process and procedures regarding AIP were documented, it would improve the process, reduce input errors, and ensure continuity when there is turnover.

Historically, the BRC team has added the STIP quarterly interest amounts to the participants' deferred awards on the Payout Calculation Worksheet utilized by OCIO. In some cases, BRC was not informed of an employee's retirement or termination and did not remove the name from

the worksheet. If left uncorrected, this may have resulted in payouts to former staff who were no longer plan participants.

Action Plan:
OCIO and OCFO will work together to identify appropriate teams/individuals and align their AIP award calculation roles and responsibilities to create a coordinated and streamlined process. The groups will document procedures for the AIP award calculation process to help reduce the risk of calculation errors.

OCIO will transition the responsibilities of the OCFO BRC team to their office and eliminate the need for BRC involvement with AIP award calculations.

Target date:
July 1, 2016

Appendix A

Office of the Chief Investment Officer
Annual Incentive Plan
2014-15 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 2014-2015, 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 2014-2015 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 2014-2015 spreadsheets that would lead us to believe that the basis point differentials used in determining AIP calculations were incorrect or inaccurate.

Appendix B

Office of the Chief Investment Officer
Annual Incentive Plan
Analysis of Current Practices compared to Policy, Plan and Guidelines

Outstanding Discrepancies included in FY13 Audit Report #P14A008

Topic	Regents Policy 7712	FY16 AIP	FY16 AIP Guidelines	FY13-FY16 Practice
Roles: President Regents Chairs		"Prior to the beginning of the Plan year, the AOC will provide **the President and Chairs of the Regents' Committees on Compensation and Investments with a list of Plan participants"** (p 2).	"On an annual basis, the AOC will review and approve the following:…Participants for the following Plan year…"(p 1) **No mention of President & Chairs.** Guidelines include descriptions of "Roles" (p 2), but there aren't any defined for the President & Chairs of Regents committees.	**Variance between Plan and Guidelines.**
Award Opportunity Levels	III.A. Plan Document"…The Plan document will include the following elements: ... Award opportunity levels (e.g**., threshold, target and maximum), when appropriate** …" (p 2-3).	"Each performance objective will include standards of performance defined as follows: Threshold…Target…Maximum" (p 4)		**Variance between Plan and Practice.** None of the participant subjective/qualitative objectives include standards of performance (Target, Threshold, Max).
Retirement and involuntary separation (added FY15)		"Participants who retire, become totally disabled, or involuntarily separate (due to reorganization or restructuring) are eligible to receive a prorated incentive award for the current Plan year and a lump sum payment of the deferred portion(s) of approved awards from	Guidance not provided regarding involuntary separation or retirement.	A reference in the Guidelines would provide additional clarity.

		prior years that have not yet been paid … and associated interest, based on the date of separation of employment from the University. (p3)		