

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

August 8, 2019

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

**RE: Final Report Project No. P19A005: Office of the Chief Investment Officer Annual Incentive Plan**

Attached is a copy of the final report for: Audit Services Project No. P19A005 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  
Chief Operating Officer Guimaraes  
Chief of Staff Henderson  
Director Huang  
Systemwide Associate Audit Director Cataldo  
Compensation Analyst Cunningham  
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. P19A005  
February 2019

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) 2018-19 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 Regent's 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. They also calculate and provide, 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 FY18. Once these were approved by the Regents, Mercer developed a new 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.

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 the Chief Financial Officer, the Vice President - Human Resources, and the Executive Director – Compensation Programs and Strategy. The latter position is currently vacant. 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 remain under the purview of the Regents, thus requiring their approval. As of September 2017, awards that place an incumbent's total cash compensation at or above \$310,000 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 objective of the OCIO AIP incentive plan audit was to assess the accuracy of FY18 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 FY18 award calculations and verified the eligible participants. For each participant, we verified the following:

- FY18 actual earnings
- AIP award opportunity percentages
- performance measure weightings
- subjective performance rating
- award opportunity
- pro-rated FY18 payout

We reviewed the FY18 payout calculations and verified:

- the initial award amounts for each participant (FY16, FY17, FY18),
- the FY18 year one payout and FY17 and FY16 deferred award payouts for each participant, as applicable,
- the spreadsheet formulas used for calculations for the FY18, FY17 and FY16 components of the payout calculation, including STIP allocations,
- the quarterly accrued STIP amounts used in the payout calculations tied to the amounts 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 FY19 participant qualitative objectives and verified with HR that they were approved by the AOC.

We also followed up on management's action plans from the prior reviews.

We performed our annual evaluation of investment performance results against source documents provided by State Street. No issues were noted in this evaluation. See Appendix A for further detail on the results of this review.

We verified that the changes made to the AIP, as reflected in the plan document and the Guidelines, were appropriately approved. Most significant, participant award calculation weightings were adjusted to place more weight on the "Entity," which is UC, compared to an individual's qualitative objectives/achievements. Where previously the individual qualitative weightings were a range from 10 – 80% per participant, it is now 25% for all positions. The weighting of the Entity component for participants previously ranged from 10 – 80%, and it is now 50 – 75%. This change also impacted the weightings for investment Asset Class/Sector Group weightings so the sum of the components remains 100%.

We performed a five-year trend analysis of participant awards and noted that the percentage of participants rated higher than meets expectations increased in FY18 to include 92% of the participants (35) compared to 80% in FY17 (28). The FY18 percentage was higher than any other year in the previous six years. The highest percentage in the prior five years was 80%.

### **Overall Conclusion**

Based on the information provided, we did not identify any errors in the calculations of the FY18 AIP award recommendations that were presented to the AOC for approval. We also did not identify any errors in the final FY18 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 opportunity for improvement:

- Following receipt of the AIP calculation model from Mercer Associates, UCOP staff made changes, including adding the payout calculations. Currently, there is no review/documentation process or change log to provide quality assurance over the calculation model.

For a detailed discussion of this issue, including the management action plan, please refer to the subsequent pages of this report.

## Opportunity for Improvements and Action Plans

### **1. There is no change management process related to the award and payout calculation model.**

During our review we noted that changes, such as payout calculation functionality, were made to the model after it was received from Mercer. A review of these changes identified an error as the location of referenced columns had not been updated. While these errors did not affect the payout calculations, a lack of a change management and/or quality assurance process could allow for future errors affecting payout calculations to go undetected. Quality assurance would be improved if HR Executive Compensation worked with the OCIO to implement a change management process, including a log of changes made and results of testing, to ensure changes are monitored and verified.

#### ***Action Plan:***

*1. HR Executive Compensation, in consultation with OCIO, will draft a change management process which will include a log of changes and testing by someone other than the person making the change.*

#### ***Target date:***

*Draft a change management process: Completed prior to issuance of this report.*

*2. In advance of future award calculations, HR Executive Compensation will request Mercer review the calculation model, including any changes from FY19.*

#### ***Target date:***

*Mercer complete review and any resulting concerns addressed by HR Compensation: September 30, 2019.*

### **2. Evidence of AOC approval of FY18 participant awards and FY19 objectives was not timely.**

Evidence of AOC approvals were previously obtained by having the designated Chair of the AOC sign and date the AOC meeting minutes that included the AOC approved actions, however this practice was discontinued as a result of personnel changes. While there are AOC meeting minutes that indicate the award and objective approvals, those AOC minutes currently do not have a signoff and there are not minutes from a subsequent meeting to indicate such approval. An approval confirmation, such as a signature or similar verification method, would serve to acknowledge that the approval statements reflected in the AOC meeting minutes are accurate.

***Action Plan:***

*HR Executive Compensation will institute a process to document decisions made by the AOC and will obtain retroactive sign-offs for the FY18 AIP awards and the FY19 AIP objectives.*

***Target date:***

*Completed prior to issuance of this report.*

## Appendix A

### **Office of the Chief Investment Officer Annual Incentive Plan FY2017-2018 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 FY2017-2018 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 2017-2018 Performance Versus Annual Incentive Plan Performance Standards."