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

December 21, 2017

CHIEF INVESTMENT OFFICER BACHHER
EXECUTIVE DIRECTOR LARSEN

RE: Final Report Project No. P18A008: OCIO Annual Incentive Plan

Attached is a copy of the final report for: Audit Services Project No. P18A008 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 Bustamante
Associate Chief Investment Officer Guimaraes
Director Huang
Director Fernandez
Systemwide Audit Manager Cataldo
Data Manager Zorn
Senior Analyst Ardeshir
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. P18A008
October 2017

Work Performed by:
Contract Auditor Harrigan
Data Manager Zorn

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

Executive Summary

Introduction

As part of the University of California Office of the President (UCOP) 2017-18 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 and investment 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).

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 six years, the Office of the Chief Financial Officer (OCFO) has assisted in the calculation of the AIP awards. In prior years a third party (Mercer) performed this activity.

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). The OCFO typically calculates the annual awards and provides HR-Compensation the award amount for each participant based on the data provided.

For Investment Officers and 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). In prior years, OCFO's Business Resource Center (BRC) entered the quarterly short term investment pool (STIP) interest amounts in the Payout workbook and then OCIO calculated participant payouts for the current year. This year, due to staff changes in BRC, the activity was performed by the OCIO.

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, was established to provide oversight of plan development, governance and interpretation. Effective FY12, the AOC was also delegated authority by the Regents to approve nonmaterial 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 2016, awards that place an incumbent's total cash compensation at or above $304,000 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 FY17 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 were met.

We tested 100% of participants' award calculations and verified the integrity of the FY17 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.

We reviewed the FY17 payout calculation and verified:

- the initial award amounts for each participant (FY15, FY16, FY17),
- the FY17 year one payout and FY15 and FY16 deferred award payouts for each participant,
- the spreadsheet formulas used for calculations for the FY15, FY16 and FY17 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 FY18 participant qualitative objectives and confirmed they were approved in July, close to the end of the plan year, as required by the Plan. We also verified that the FY17 participant awards were approved by the AOC or the Regent's Committee on Compensation, as appropriate.

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 and Cambridge Associates. No issues were noted in this evaluation. See Appendix A for further detail on the results of this review.

We noted there was a minor enhancement to the FY17 Guidelines compared to the prior year and these changes were appropriately approved.

We performed a five year trend analysis of participant awards and noted that the percentage of participants rated higher than meets expectations increased in FY17 to include 80% of the participants (28) compared to 60% in FY16 (18). The FY17 percentage was higher than any other year in the previous five years. The highest percentage in the prior five years was 67%.

Overall Conclusion
Based on the information provided, we did not identify any errors in the calculations of the FY17 AIP award recommendations that were presented to the AOC and the Regents Committee on Compensation for approval. We also did not identify any errors in the final FY17 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:

- There was a lack of segregation of duties as the FY17 award payout workbook was prepared by an AIP participant from the OCIO rather than by the OCFO. In the past, the OCIO performed a reviewer function.
- The award calculation model could be enhanced to improve accuracy. The two payout models could be combined into one workbook and the use of Excel tables could enhance efficiency and accuracy. While several discrepancies and data input errors 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 and Regent’s approval and payout.
- AIP Administrative Guidelines (Guidelines) document needs to be updated to include current investment performance objectives and plan changes effective in FY18.

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

Opportunities for Improvement and Action Plans

1. **There was a lack of a segregation of duties related to the participant payout calculations.**

During our review we noted that an AIP participant prepared the FY18 AIP award payout calculation workbook and, as a result, calculated her own payout. Audit reviewed the initial calculations and noted an incorrect column was referenced in the participant award calculations that resulted in inaccurate totals calculation. All errors were corrected prior to the final results being forwarded to the CIO for approval and prior to release to Payroll.

Appropriate segregation of duties ensures that there is oversight and review to catch and help prevent errors and fraudulent activity. The segregation of duties concept prohibits the assignment of responsibility to one person for the transaction initiation and subsequent authorization and record keeping.

In prior years, OCIO provided OCFO the current year participant awards and OCFO updated the workbook including adding quarterly STIP interest to the deferred awards from prior years. Subsequently, OCIO would review the workbook prior to forwarding the payout amounts for each participant to Payroll. The person in OCFO who previously performed these responsibilities retired and the above identified calculation process was done for expediency. Procedures can be strengthened if someone outside OCIO prepared the payout workbook and OCIO returned to the reviewer role.

Action Plan:
OCIO and OCFO will review roles and responsibilities and enhance them to ensure that, going forward, duties are segregated regarding award and payout calculations.

Target date:
March 31, 2018

2. **Changes to the calculation model should be implemented to increase efficiency and accuracy.**

Enhancements to the calculation model should be considered to address changes to the plan document and to improve overall efficiency.

There are currently two workbooks, one used to calculate the current year awards and one used to calculate the current year payout which includes deferred payments and related interest. Combining the two into one workbook would be more efficient and enhance accuracy.

We also noted that the award calculation workbook does not utilize MS Excel tables to avoid changes to the references (calculation, cells). For example, the *Recommended Award Opportunity and Selection & Weighting of Performance Measures* should lookup values from tables stored in an additional column that represents the plan position and *Years in Plan.* A feature of Excel Tables is that they can automatically detect inconsistent formulas in adjacent cells.

The model should also ensure that it properly accounts for the following changes:

- The Private Equity asset class did not previously have a benchmark but beginning in FY2018, one is being phased in over several years. A multi-year benchmark is also being phased in for UCRP private equity asset class.
- The General Endowment Pool (GEP) public equity benchmark previously had four separate benchmarks but now has one benchmark. The GEP absolute return benchmark was also changed.
- The former fixed income asset class had four separate benchmarks but is now called the Liquidity (Income) asset class which has one benchmark.

Action Plan:
OCIO has determined that a new model needs to be designed, developed, and tested prior to FY18 award calculations. The new model will perform the calculations that were previously separated in two different models, the calculation model and the payout model which included deferred awards and interest. OCIO will consider both internal and external options, such as a third party, to accomplish this task, improve efficiency, and enhance accuracy.

Target dates:
Complete master plan, timeline and project roles and responsibilities: January 30, 2018
New model available for user testing: April 30, 2018

3. AIP Administrative Guidelines have not been updated for FY18.

The Regents Governance and Compensation Committee approved changes to the FY18 AIP plan document and to the FY18 investment performance objectives. Critical changes to the plan included making it consistent with the revised Regents Policy 7712, clarifying termination provisions, adjusting the transition plan for new hires, and changing the incentive targets for Managing Directors. These changes have not yet been incorporated into the AIP Administrative Guidelines.

Action Plan:
Based on the changes approved by the Regents' Committee, Systemwide HR Compensation will revise the Guidelines as needed and forward to OCIO for review.

Target dates:
HR and OCIO will conduct a planning meeting to review changes and discuss edits to Guidelines: January 31, 2018
New Guidelines issued: January 31, 2018

Appendix A

Office of the Chief Investment Officer
Annual Incentive Plan
2016-17 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 2016-2017, 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 2016-2017 Performance Versus Annual Incentive Plan Performance Standards).

Based on this review, we identified one calculation error which was corrected prior to the final version of the 2016-2017 spreadsheets. We believe that the basis point differentials used in the AIP award calculations were correct and accurate.