



May 10, 2016

Mr. Bruce Zimmerman
Chief Executive Officer and Chief Investment Officer
The University of Texas Investment Management Company
401 Congress Avenue, Suite 2800
Austin, Texas 78701

Dear Bruce:

We have completed our audit of certain processes over The University of Texas Investment Management Company's (UTIMCO) Separately Managed Accounts. The detailed report is attached for your review.

We conducted our audit in accordance with The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*.

We appreciate the assistance provided by management and personnel from UTIMCO.

Sincerely,

J. Michael Peppers, CPA, CIA, QIAL, CRMA
Chief Audit Executive

cc: Joan Moeller, Sr. Managing Director - Accounting, Finance and Administration, UTIMCO
Cissie Gonzalez, General Counsel and Chief Compliance Officer, UTIMCO
Mark Warner, Sr. Managing Director - Natural Resources Investments, UTIMCO
Susan Chen, Managing Director - Public Markets Investments, UTIMCO
Francie Frederick, General Counsel to the Board of Regents, UT System
Dan Sharphorn, Vice Chancellor and General Counsel, UT System
Scott C. Kelley, Ed. D., Executive Vice Chancellor for Business Affairs, UT System
Terry Hull, Associate Vice Chancellor for Finance, UT System

**The University of Texas System Administration
The University of Texas Investment Management Company
Separately Managed Accounts (SMAs) Audit Report
FY 2015**



May 2016

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**The University of Texas Investment Management Company
UTIMCO Separately Managed Accounts Audit Report
Fiscal Year 2015**

AUDIT REPORT

May 2016

EXECUTIVE SUMMARY

The University of Texas Investment Management Company (UTIMCO) is a 501(c)(3) corporation that was formed to manage investments for The University of Texas and Texas A&M Systems. As reflected in the UTIMCO Bylaws that were approved by The University of Texas (UT) System Board of Regents (BOR), the BOR has delegated direct oversight and governance of UTIMCO to the UTIMCO Board of Directors (UTIMCO Board). The UTIMCO's Bylaws also describe a Delegation of Authority Policy that is subject to the UTIMCO Board's review and approval. Through this policy, the UTIMCO Board delegates operational and investment authority, up to specified limits, to UTIMCO management and staff.

In accordance with the Investment Management Services Agreement (IMSA) between the BOR and UTIMCO and the Investment Policy Statements approved by the BOR, UTIMCO may invest in various asset classes and pursue different investment strategies. This includes investing in Separately Managed Accounts (SMA). A SMA is a portfolio of assets managed by an external investment manager in accordance with an Investment Advisory Agreement (IAA). The IAA outlines the fee structure, investment guidelines, and other provisions while the BOR, through a custodian bank, retains ownership and custody of the assets. In some cases, UTIMCO establishes limited liability companies (LLCs) for the sole purpose of entering into an IAA to invest in a SMA. The LLC structure is intended to protect the endowment funds and mitigate risks associated with certain investments.

This audit was included as part of the Fiscal Year (FY) 2015 audit plan requested by UTIMCO management during the annual risk assessment process. The objectives of this audit were to gain an understanding of the SMAs and determine whether: (1) initial due diligence controls prior to entering into an investment with a new manager are in place and functioning; (2) ongoing due diligence, monitoring, and reporting activities are being performed; and (3) certain processes are operating to help ensure accurate accounting of funds. The scope of the audit included all SMAs as of May 31, 2015. As of that date, UTIMCO had 33 SMAs valued at approximately \$8.8 billion.

To achieve our objectives, we reviewed UTIMCO's internal policies and procedures; conducted interviews with relevant UTIMCO staff to gain an understanding of processes for establishing, monitoring, and accounting for SMAs; and tested selected processes and controls to determine whether they were in place functioning as intended.

RESULTS

UTIMCO performs comprehensive due diligence steps to obtain a thorough understanding of potential investments and external managers. For investments made, UTIMCO performs ongoing due diligence, monitoring, and reporting activities and has processes in place to ensure accurate accounting of funds. Based on the testing performed, we determined that UTIMCO's due diligence controls and accounting processes appear to be in place, and most are functioning as intended; however, we identified one Priority¹ finding:

¹ A Priority Finding is defined as an issue identified by an internal audit that, if not addressed timely, could directly impact achievement of a strategic or important operational objective of a UT institution or the UT System as a whole. Non-Priority Findings are ranked as High, Medium, or Low, with the level of significance based on an assessment of applicable Qualitative, Operational Control, and Quantitative risk factors and probability of a negative outcome occurring if the risk is not adequately mitigated.



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1. The current design of Option to Review Proposed Investments (Option to Review) process enables the UTIMCO Board to delegate to UTIMCO staff authority to execute proposed investments above staff's stated investment authority which is detailed in the Delegation of Authority Policy. The current process requires that each UTIMCO Board member select one of three options before the proposed investment is executed. UTIMCO staff cannot execute a proposed investment above its stated authority unless all UTIMCO Board members unanimously select an option that allows the investment to proceed without any further UTIMCO Board action. The Option to Review Process takes place outside of an official meeting.

In addition to the finding above, the IMSA does not appear to be sufficiently clear on whether UTIMCO management or the UTIMCO Board has delegated authority set up a separate legal entity on behalf of the BOR. Currently, UTIMCO does not have a process in place to inform the BOR or the Office of the BOR of the existence of the Limited Liability Companies (LLCs) set up on behalf of the BOR or their purpose and performance. In addition, opportunities exist to clarify the Certificate of Compliance Procedures and the Delegation of Authority Policy.

RECOMMENDATION SUMMARY

To address the observations described above, we have recommended the following:

- UTIMCO staff and UTIMCO Board should review and modify the current Option to Review process, and consequently the Delegation of Authority Policy, by clarifying when UTIMCO Board action is necessary and when a proposed investment above UTIMCO staff's delegated authority may proceed without UTIMCO Board action.
- UTIMCO, in coordination with UT System management, should update the IMSA with the revised provisions regarding approval of new separate legal entities on behalf of the BOR. After approval of an LLC, UTIMCO management should ensure that it informs the Office of the BOR that an LLC has been established. In addition, UTIMCO should implement a process to report newly-established LLCs to the BOR, including their purpose and performance.
- UTIMCO should clarify its procedures to specify that Certificates of Compliance must be signed by the date the IAA is signed or the effective date of the IAA, whichever occurs earlier, and consider retaining documentation of reasons why certain individuals did not complete the certificates.
- UTIMCO should clarify its Delegation of Authority Policy to specify how and when delegation of authority calculations should be documented.

CONCLUSION

UTIMCO's controls over initial due diligence, ongoing due diligence, and accounting processes are in place and most are functioning as intended. However, opportunities exist to strengthen controls related to the Option to Review process and the approval and communication of LLCs set up on behalf of the BOR. In addition, the Certificate of Compliance and Delegation of Authority Policy should be clarified.

J. Michael Peppers, CIA, CPA, QIAL, CRMA
Chief Audit Executive

Eric J. Polonski, CIA, CPA
Assistant Director of Audits



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BACKGROUND

The University of Texas Investment Management Company (UTIMCO) is 501(c)(3) corporation that was formed to manage investments for The University of Texas and The Texas A&M University Systems. In 1996, The University of Texas (UT) System Board of Regents (BOR) first contracted with UTIMCO to invest in several major endowment funds under its fiduciary control, including the Permanent University Fund (PUF), the General Endowment Fund (GEF), the Intermediate Term Fund (ITF), and the Separately Invested Funds (SIFs). Collectively known as “the Funds,” these endowments were valued at approximately \$33.1 billion as of August 31, 2015². The BOR has fiduciary responsibility for the Funds and has delegated day-to-day management of the Funds to UTIMCO, pursuant to the Investment Management Services Agreement (IMSA) between the BOR and UTIMCO.

According to the UTIMCO Bylaws, the UTIMCO Board of Directors (UTIMCO Board) is composed of nine members, seven of whom are appointed by the BOR. Of the seven UTIMCO Board members appointed by the BOR, at least three are also members of the BOR; three must have “substantial background and expertise in investments”; and one must be a “qualified individual as determined by the Board of Regents, which may include the Chancellor of The University of Texas System.” The remaining two UTIMCO Board members are appointed by the Board of Regents of The Texas A&M University System. The BOR approves UTIMCO’s Bylaws, which describes a Delegation of Authority Policy that is approved by the UTIMCO Board. Through its Delegation of Authority Policy, the UTIMCO Board delegates operational and investment authority, up to specified limits, to UTIMCO management and staff.

In accordance with the IMSA and Investment Policy Statements approved by the BOR, UTIMCO may invest in various asset classes and pursue different investment strategies. This includes investing in Separately Managed Accounts (SMA). A SMA is a portfolio of assets managed by an external investment manager in accordance with an Investment Advisory Agreement (IAA). An advantage of a SMA is that it provides more transparency into the individual assets, which are owned by the BOR and held by the Bank of New York (BNY) Mellon, the BOR’s custodian bank. In contrast, investors in a commingled fund own shares of the fund but not the underlying securities.

The IAA outlines the terms of agreement between UTIMCO and the external investment manager, including the fee structure, investment guidelines, and other provisions. In certain instances, UTIMCO establishes limited liability companies (LLCs) for the sole purpose of entering into an IAA to invest in a SMA. In general, parties to the IAAs include the external investment manager and the LLC as the client. UTIMCO serves as manager of the LLC, with the BOR being as sole member of the LLC. The LLC structure is intended to protect the Funds managed by UTIMCO on behalf of the BOR and mitigate risks associated with certain investments.

This audit was included as part of the Fiscal Year (FY) 2015 audit plan at the request of UTIMCO management made during the annual risk assessment process.

AUDIT OBJECTIVES

The objectives of this audit were to gain an understanding of the SMAs and determine whether:

1. Initial due diligence controls prior to entering into an investment with a new manager are in place and functioning;
2. Ongoing due diligence, monitoring, and reporting activities are being performed; and

² This information was obtained from the UTIMCO Performance Summary, August 31, 2015.



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3. Certain processes are operating to help ensure accurate accounting of funds.

SCOPE

The scope of the audit included all SMAs as of May 31, 2015. As of that date, UTIMCO had 33 SMAs valued at approximately \$8.8 billion. We focused our testing on five SMAs from the Emerging Markets Equity and Natural Resources Asset Classes.

METHODOLOGY

To achieve our objective, we reviewed UTIMCO's internal policies and procedures; conducted interviews with UTIMCO staff to gain an understanding of processes for establishing, monitoring, and accounting for SMAs; and tested selected processes and controls to determine whether they were in place and functioning as intended.

We also gained an understanding of the consolidation process for SMAs by reviewing documentation and speaking with accounting staff. The consolidation process is necessary to incorporate the detailed holdings and activity of a SMA into the Funds' general ledgers. We also inquired about valuation processes. However, we did not perform specific testing procedures related to the consolidation or valuation processes as these areas are included within the scope of the annual external financial audit.

We conducted our audit in accordance with the guidelines set forth in the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*.

AUDIT RESULTS

UTIMCO investment staff maintains a listing of potential external investment managers, whom they hire, based on whether a given investment fits into UTIMCO's overall investment strategy and desired exposure to various asset classes and investment types. Prior to establishing a SMA with an external investment manager, UTIMCO performs comprehensive due diligence steps to obtain a thorough understanding of the potential investment and the external manager. Effective initial due diligence controls should help prevent execution of investments that expose the Funds to undue risk. Subsequent to investing in a SMA, UTIMCO performs ongoing due diligence, monitoring, and reporting activities to stay informed of material account activity. Effective ongoing due diligence controls should help identify accounts that are being poorly managed or not managed in accordance with IAAs. Based on testing performed, we determined that UTIMCO has adequate controls in place over its due diligence and accounting processes; however, we identified opportunities for UTIMCO to strengthen existing controls and improve consistency for certain activities.

Option to Review Investment Proposal Process

In 2007, the UTIMCO Board approved changes to the Delegation of Authority Policy, which describes responsibilities of the UTIMCO Board and UTIMCO management in making investment decisions. These changes included updating the UTIMCO Board Option to Review Proposed Investments (Option to Review) process for any proposed investments that exceeds UTIMCO management's stated investment authority to execute an investment. For example, using the Net Asset Value (NAV) of Applicable Assets as of the fourth quarter end of FY 2015, the Option to Review process would be initiated for a proposed



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new investment exceeding \$496,960,500³. Another key limitation pertains to the percentage of total assets managed by a particular manager. Prior to November 2014, the thresholds limited total assets managed by an internal or external manager to less than 20% of the total assets managed by the manager in the applicable investment strategy unless the Option to Review process was followed. In November 2014, the Delegation of Authority Policy was revised, as approved by the UTIMCO Board, to increase this limit to 50%. (See *Appendix A* for a summary of key investment limits from the Delegation of Authority Policy.)

When a proposed investment exceeds UTIMCO staff's stated investment authority, the Option to Review process is initiated. During this process, each UTIMCO Board member is presented with a formal investment recommendation, which describes the proposed investment and contains research performed by UTIMCO staff. Each UTIMCO Board member is also provided an Option to Review Investment Proposal Form that includes the following alternatives, of which only one may be selected:

1. The UTIMCO Board member does not require a complete review of the proposed investment prior to execution; or
2. The UTIMCO Board member does not require a complete review of the proposed investment prior to execution but requests that a presentation regarding the investment be made at a future UTIMCO Board meeting; or
3. The UTIMCO Board member requires a complete review of the proposed investment prior to execution (at the next UTIMCO Board meeting).

If options #1 or #2 are selected, UTIMCO may proceed to execute the proposed investment, but only after the Option to Review process is completed. In order to complete the process, each UTIMCO Board member is required to select one alternative and sign an Option to Review Investment Proposal Form. UTIMCO staff will not execute a proposed investment until all completed and signed forms are returned and until after the selected options are compiled and results known. Only after unanimous selection, where each UTIMCO Board member "does not require a complete review of the proposed investment prior to execution," may UTIMCO staff proceed with executing the proposed investment. However, if a single UTIMCO Board member requires a complete review (i.e., selects option #3), then the proposed investment would be placed on the agenda of a UTIMCO Board meeting and the UTIMCO Board members would vote on whether to approve the proposed investment. Historically, the UTIMCO Board members have not required a complete review, allowing UTIMCO staff to execute the proposed investment without any further UTIMCO Board action. According to the UTIMCO Board's meeting materials for the November 18, 2014 meeting, the option to review process was initiated 33 times (out of 158 investments) from FY 2012 through FY 2014. In none of those instances was option #3 selected. During this time frame, the Option to Review process was most often initiated when proposed investments or increases to existing investments managed by an external or internal manager exceeded 20% of the total assets managed by the manager in the applicable investment strategy.

³ Under the Delegation of Authority Policy that became effective November 18, 2014, there are very specific limits of UTIMCO's investment authority for different investment scenarios. For More Correlated & Constrained (MCC) Investments, under which the SMAs are categorized, new investments greater than 1.5 percent of Applicable Assets would initiate the Option to Review process. For the MCC Investment Type, Applicable Assets represent the total combined NAV of the Endowments and ITF determined as of the most recent quarter-end close of books. For the example in our report, we used the NAV of Applicable Assets obtained from the UTIMCO's Summary of Assets Under Management as of August 31, 2015, that is available from UTIMCO's website, with the assumption of a new, hypothetical investment being proposed in September 2015.



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The Option to Review process takes place outside of an official meeting. One reason for implementing this process was to allow investment decisions to proceed expeditiously; however, we believe that it could be perceived that the UTIMCO Board is taking action since:

- A. Each member is required to affirmatively select one of three options, and
- B. UTIMCO cannot execute a proposed investment above its stated investment authority unless all members unanimously respond to allow an investment to be executed without subsequent approval by the UTIMCO Board.

We were informed by UTIMCO staff and UTIMCO's outside counsel that there is no intent of the Option to Review process to circumvent an official action of the UTIMCO Board. We were also informed that the process was established to give any member of the UTIMCO Board an option to review a proposed investment, without collective deliberation, and place that investment on the UTIMCO Board agenda for a vote. If no single member requested that a proposed investment be placed on the agenda, UTIMCO staff may proceed to execute the investment without a UTIMCO Board action. UTIMCO staff and UTIMCO counsel do not believe that the UTIMCO Board is taking an action outside of an official meeting; however, they have agreed that the process can be clarified.

The observation described above is considered a **priority-level** finding in accordance with UT System's Internal Audit finding classification system.

Recommendation: UTIMCO staff and UTIMCO Board should review and modify the current Option to Review process, and consequently the Delegation of Authority Policy, by clarifying when UTIMCO Board action is necessary and when a proposed investment above UTIMCO staff's stated authority may proceed without UTIMCO Board action.

Management's Response: *While respectfully disagreeing with the Report's characterization of the Option to Review process, UTIMCO staff has nonetheless prepared a draft of proposed revisions to the Delegation of Authority Policy. The revised policy will eliminate the Option to Review process. It will also clarify that the Policy delegates complete investment authority to staff, subject only to a prudent fiduciary control entitling any single Director to submit a written request requiring a Board vote on whether or not to approve a proposed investment that exceeds one of the investment thresholds set forth in the revised Delegation of Authority Policy. The thresholds are not changed by the revisions. UTIMCO staff submits that the revised Policy should eliminate any uncertainty as to the lack of a requirement for Board action to approve a proposed investment that exceeds one of the thresholds, unless any single Director believes that such action is warranted or appropriate.*

Implementation Date: *This recommendation has been **implemented**. UTIMCO staff presented the revised Delegation of Authority Policy to the UTIMCO Board's Policy Committee and the UTIMCO Board for adoption. The UTIMCO Board approved the revised Delegation of Authority Policy on May 5, 2016.*

Formation and Disclosure of Limited Liability Companies

To manage risks associated with certain investments and further protect the Funds, UTIMCO management has established limited liability companies (LLCs) to invest in certain SMAs. Currently, UTIMCO has approximately 20 LLCs. For the five SMAs we tested, the BOR is the sole member of each LLC. UTIMCO management executed legal documents establishing the LLCs on behalf of the BOR.



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UTIMCO indicated that it has the authority to do so in accordance with the IMSA between UTIMCO and the BOR; however, the IMSA does not appear to be clear on whether UTIMCO management or the UTIMCO Board has sufficient delegated authority to establish a separate legal entity on behalf of the BOR.

In the event that legal action is taken against a UTIMCO-registered LLC, the BOR might be exposed to the risk of litigation and unaware that the LLC even existed. While UTIMCO is using LLCs to protect the assets of the BOR, and three members of the BOR also serve on the UTIMCO Board, the full BOR may not be aware that such action is being taken on their behalf because there is currently no formal reporting of all LLC activity directly to the BOR or to the Office of the BOR. In addition, UTIMCO does not have a process in place to inform the BOR or the Office of the BOR of the existence of the LLCs, their purpose, or their performance.

The observation described above is considered a **high-level** finding in accordance with UT System's Internal Audit finding classification system.

Recommendation: UTIMCO should work with the Office of the BOR to establish an agreed-upon process to form new LLCs, specifying who must approve their creation. Based on that understanding, UTIMCO and UT System should update the IMSA with the revised provisions regarding approval of new separate legal entities on behalf of the BOR. Before any additional LLCs are established, the BOR would need to approve the change to the IMSA. After approval of a LLC, UTIMCO management should ensure that it informs the Office of the BOR that a LLC has been established. In addition, UTIMCO should implement a process to report newly-established LLCs to the BOR, including their purpose and performance. Reporting should occur annually. The form of reporting may be determined by UTIMCO management and coordinated, if necessary, with the Office of the BOR.

Management's Response: *The establishment of an LLC is for the purpose of protecting the assets of the Board of Regents of The University of Texas System. Any LLC established is approved in advance by UTIMCO's CEO with full knowledge of the reasons for its necessity. As previously discussed with the auditors, in addition to service of three members of the BOR and the Chancellor on the UTIMCO Board, staff from the UTIMCO Office of Finance receive copies of all Investment Recommendations, copies of all investment summaries accompanying certificates of compliance, participate in UTIMCO portfolio reviews, committee and board meetings and as such have been put on notice regarding the formation of any LLCs. Notwithstanding the foregoing, UTIMCO will develop a process to annually report to the Board office all existing LLCs.*

Anticipated Implementation Date: July 1, 2016

Initial Due Diligence

Prior to establishing a SMA with an external investment manager, UTIMCO performs comprehensive due diligence steps to obtain a thorough understanding of the potential investment and the external manager. Key due diligence steps include completion of a due diligence questionnaire by the external manager, quantitative analysis of investment performance, background checks on the external manager and team, and reference calls to current and former employers, employees, and investors.



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Additionally, UTIMCO is required to complete and maintain certain key documents related to establishing the SMA. These include a two-page summary of a proposed recommendation and formal investment recommendation, which addresses investment strategy, merits, and how the investment fits in UTIMCO's portfolio; a Mandate Categorization Form used to identify the investment type and asset class; and Certificates of Compliance signed by all UTIMCO Board members and designated Key Employees to identify potential conflicts of interest.

UTIMCO has adequate controls in place over its initial due diligence process. When operating effectively, these controls should help prevent UTIMCO from entering into agreements with external investment managers that expose UTIMCO to undue risk. In most cases, these controls were functioning as intended. Specifically, for all five SMAs tested, UTIMCO:

- Ensured that its rationale for selecting the external manager was adequately documented in a two-page summary and formal Investment Recommendation;
- Retained documentation supporting that it worked with internal and external legal counsel when executing and filing legal agreements and LLC documents;
- Retained documentation in due diligence binders supporting that relevant checklists, questionnaires, quantitative analyses, background checks, and reference checks were completed;
- Obtained necessary signatures for all required forms within a reasonable time of executing IAAs with the external manager; and
- Obtained Certificates of Compliance signed by all UTIMCO Board members and Key Employees as of the date the IAA was signed.

Though UTIMCO has adequate controls in place over the initial due diligence process, we identified opportunities for UTIMCO to improve its processes by clarifying the Certificate of Compliance Procedures and the Delegation of Authority Policy as described below.

Certificate of Compliance Procedure

UTIMCO's due diligence procedures state that each UTIMCO Board member and defined Key Employees are required to complete Certificates of Compliance before an investment can be made; however, these procedures do not clearly define when an "investment is made" and do not specify at what point in the process compliance must be achieved. Specifically, the procedures do not clarify whether the investment is made date is as of the date an IAA is signed or the stated effective date of the IAA. UTIMCO management considers the date an IAA is signed to be the date UTIMCO is committed to an investment. However, there were observed instances when the IAA was signed, but the date was not recorded. In such instances, we considered the stated effective date as the investment is made date. Using these criteria, all required individuals signed certificates for the SMA in question. In some cases, several months may pass from the time UTIMCO Board members and Key Employees sign Certificates of Compliance to the time that IAAs are signed and accounts funded. As a result, it is possible for both UTIMCO Board membership and personnel to change, making it unclear as to which individuals need to sign the certificates.

The observation described above is considered a **medium-level** finding in accordance with UT System's Internal Audit finding classification system.

Recommendation: UTIMCO should clarify its internal process to specify that UTIMCO Board members and Key Employees are required to sign Certificates of Compliance by the date an IAA



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is signed or the effective date of the IAA, whichever occurs earlier. Additionally, UTIMCO should retain documentation of reasons why certain individuals did not complete the certificates.

Management's Response: *The auditors identified no instances of noncompliance with the Certificates of Compliance Procedure, i.e., all required certificates of compliance were signed and received prior to committing to an investment. However, UTIMCO will clarify its internal process, including the date that will be used as the date the "investment is made." UTIMCO staff believes it maintains adequate documentation regarding those individuals that must complete the certificates prior to the date an investment is made but will also revisit those processes and determine if changes are needed.*

Anticipated Implementation Date: July 1, 2016

Delegation of Authority Policy

UTIMCO staff performs handwritten calculations to determine whether proposed investments exceed monetary limits stated in the UTIMCO Delegation of Authority Policy. This allows staff to determine whether the UTIMCO Board members need to complete Option to Review Investment Proposal Forms. The policy includes multiple thresholds and ratios that may apply based on the nature of the proposed investment and UTIMCO's existing relationship with the external manager; however, the policy does not specify how or when delegation of authority calculations should be documented. For the sample of SMAs tested, the handwritten delegation of authority calculations did not consistently describe what specific section of the policy was being applied nor did those calculations demonstrate that all applicable ratios and thresholds were tested. We also noted that the handwritten calculations used "proposed funding" as opposed to actual funding amounts. In some cases, it may be obvious to UTIMCO staff that a proposed investment will not exceed the monetary limits in the policy. In such instances, staff do not document and retain all calculations performed on proposed, actual, or additional funding. As a result, UTIMCO does not consistently retain formal documentation that investment amounts complied with its Delegation of Authority Policy.

The observation described above is considered a **medium-level** finding in accordance with UT System's Internal Audit finding classification system.

Recommendation: UTIMCO should clarify its Delegation of Authority Policy to specify how and when delegation of authority calculations should be documented. Additionally, in instances when more than three months have passed since the initial testing of delegated authority limits and initial funding of the investment, UTIMCO should determine whether it is appropriate and feasible to retest against the policy using current amounts at the time of funding.

Management's Response: *The Delegation of Authority Policy sets the limits of the investment amounts but does not address how the calculation should be performed or documented. As such, UTIMCO staff will not make changes to the Delegation of Authority Policy with respect to the calculations and documentation. UTIMCO staff will however, ensure that its calculations are appropriately documented.*

Anticipated Implementation Date: July 1, 2016



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Ongoing Due Diligence, Monitoring, and Reporting

Subsequent to investing in a SMA, UTIMCO performs ongoing due diligence, monitoring, and reporting activities. These activities include holding regular meetings with the external manager, preparing periodic activity reports to evaluate SMA performance against benchmarks, and verifying external manager compliance with investment guidelines as outlined in the IAA.

UTIMCO has adequate controls in place over its ongoing due diligence process. When operating effectively, these controls should help UTIMCO identify accounts that are being poorly managed or not managed in accordance with IAAs. These controls were functioning as intended. Specifically, for all five SMAs tested, UTIMCO:

- Prepared extensive spreadsheets and semi-annual portfolio reviews during FY 2015 to monitor and evaluate various aspects of the external manager's performance;
- Reported SMA performance to the UTIMCO Board during FY 2015 through the Investment Performance Detail Summary;
- Verified external manager compliance with guidelines established in the IAA during FY 2015 by conducting both automated and manual testing;
- Conducted meetings, phone calls, and onsite visits with the external manager from the inception of the SMA through FY 2015;
- Obtained updated due diligence questionnaires annually from the inception of the SMA through FY 2015; and
- Submitted renewal background checks every five years on the external manager and team from the inception of the SMA through FY 2015.

Accounting Processes

UTIMCO had adequate controls in place over SMA accounting processes. When operating effectively, these controls should help ensure accurate accounting of funds. In most cases, these controls were functioning as intended. Specifically:

- For all five SMAs tested, accounts were established and funded by BNY Mellon as instructed by authorized UTIMCO staff. Additionally, the only withdrawal processed during FY 2015 was executed by BNY Mellon as instructed by authorized UTIMCO staff and was done so in accordance with the IAA.
- Management and performance fees charged by the external manager for the most recent invoice period in FY 2015 were accurately calculated with no material exceptions.



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Appendix A

Summary of Key Investment Limits From the Delegation of Authority Policy as of November 2014				
Description	More Correlated and Constrained (e.g., Publicly Traded Securities)	Less Correlated and Constrained (e.g., Hedge Funds)	Private Investments	Private Co-Investments
Limits for New Managers and Mandates (i.e., New Investments)	1.5% of Applicable* Assets	1.0% of Applicable Assets*	0.75% of Applicable Assets^	0.3% of Applicable Assets^
Limits for New Investments in Dollars	\$496,960,500	\$331,307,000	\$195,706,500	\$78,282,600
Limits for Changes in Allocations for Existing Managers	1.0% of Applicable* Assets	0.75% of Applicable Assets*	0.50% of Applicable Assets^	0.3% of Applicable Assets^
Limits for Changes in Dollars	\$331,307,000	\$248,480,250	\$130,471,000	\$78,282,600
Key limitation that is not specifically dependent on the NAV of Applicable Assets:		“No commitment or increase shall be permitted which increases the Total Assets managed by an internal or external manager to more than 50% of the Total Assets managed by the manager in that investment strategy.”		
*Applicable Assets for MCC and LCC is the NAV of the Endowments and ITF determined as of the most recent quarter-end close of books. For this Appendix, the NAV of Applicable Assets as of the end of the fourth quarter of FY 2015 (i.e., August 31, 2015) was \$33,130,700,000.				
^Applicable Assets for Private Investments is the NAV of the Endowments determined as of the most recent quarter-end close of books. For this Appendix, the NAV of Applicable Assets as of as of the end of the fourth quarter of FY 2015 (i.e., August 31, 2015) was \$26,094,200,000.				