



May 22, 2013

To: Finance and Administration Committee

From: Darrell Johnson, Chief Executive Officer

Subject: Review of Investment Management Contracts for the Bond Proceeds Portfolio

Overview

The Internal Audit Department has completed a review of contract compliance and management controls related to contracts with Cutwater Investor Services Corporation and Logan Circle Partners, L.P., investment managers of the Orange County Transportation Authority's bond proceeds portfolio. Based on the review, the investment managers are providing services in accordance with their contracts and invoices paid are in compliance with contract payment provisions, policies, and procedures. However, the Internal Audit Department has made two recommendations related to the reporting of yields and returns in investment and debt reports and Board of Directors' approval of contracts with terms greater than five years.

Recommendation

Direct staff to implement recommendations provided in the Review of Investment Management Contracts for the Bond Proceeds Portfolio, Internal Audit Report No. 13-522.

Background

The Treasury/Toll Roads Department (Treasury) is responsible for management of the Orange County Transportation Authority's (OCTA) investment portfolio. The portfolio consists of three managed portfolios: liquid assets for OCTA's daily operations, short term portfolio for future budgeted expenditures, and bond proceeds portfolio to meet Measure M2 transportation program needs. On December 31, 2012, the bond proceeds portfolio's book value was approximately \$103 million.

OCTA maintains Agreement No. C-1-2400 with Cutwater Investor Services Corporation (Cutwater) and Agreement No. C-0-1784 with Logan Circle

Partners, L.P. (Logan Circle) for investment management services for the bond proceeds portfolio.

Treasury prepares monthly investment and debt reports for the Finance and Administration Committee (F&A) and quarterly debt and investment reports for the Board of Directors (Board). These reports include information about the bond proceeds portfolio managed by Cutwater and Logan Circle, including a comparison of the yields and returns against a benchmark provided by OCTA's financial advisor.

Discussion

The Internal Audit Department (Internal Audit) tested a sample of monthly and quarterly investment and debt reports provided to the F&A and Board and found several errors. Internal Audit recommended that Treasury strengthen controls to help ensure the accuracy of these reports. Management agreed to implement an additional level of review of these reports.

Internal Audit also noted that the agreements with Cutwater and Logan Circle were executed with indefinite contract terms. Procurement policies and procedures require prior concurrence from the Board for any contract term in excess of five years. The staff report requesting authorization to execute the agreements for investment management services did not identify the contracts as having indefinite terms; therefore, it is not clear that Board concurrence was obtained. Internal Audit recommended that the Contracts Administration and Materials Management Department (CAMM) strengthen controls to ensure Board approval is specifically requested for any contract terms exceeding five years, including indefinite term contracts. CAMM agreed and indicated that controls would be strengthened to ensure staff reports request specific approval.

Summary

Based on the review, Cutwater and Logan Circle are providing services in accordance with their contracts and invoices paid are in compliance with contract payment provisions, policies, and procedures. However, two recommendations were made to improve reporting of yields and returns and to ensure Board approval is obtained for contract terms exceeding five years.

Attachment

- A. Review of Investment Management Contracts for the Bond Proceeds Portfolio, Internal Audit Report No. 13-522

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ORANGE COUNTY TRANSPORTATION AUTHORITY INTERNAL AUDIT DEPARTMENT



Review of Investment Management Contracts for the Bond Proceeds Portfolio

Internal Audit Report No. 13-522

May 10, 2013



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Conclusion

The Internal Audit Department (Internal Audit) has completed a review of contract compliance and management controls related to contracts with Cutwater Investor Services Corporation (Cutwater) and Logan Circle Partners, L.P. (Logan Circle), investment managers of the Orange County Transportation Authority's (OCTA) bond proceeds portfolio. Based on the review, the investment managers are providing services in accordance with their contracts and invoices paid are in compliance with contract payment provisions, policies, and procedures. However, Internal Audit has made two recommendations related to the reporting of yields and returns in investment and debt reports and Board of Directors' (Board) approval of contracts with indefinite terms.

Background

The Treasury/Toll Roads Department (Treasury) is responsible for management of OCTA's investment portfolio. The portfolio consists of three managed portfolios: liquid assets for OCTA's daily operations, short term portfolio for future budgeted expenditures, and bond proceeds portfolio to meet Measure M2 transportation program needs. OCTA maintains Agreement No. C-1-2400 with Cutwater and Agreement No. C-0-1784 with Logan Circle for investment management services for the bond proceeds portfolio. On December 31, 2012, the bond proceeds portfolio's book value was approximately \$103 million.

Treasury prepares monthly investment and debt reports for the Finance and Administration Committee (F&A) and quarterly debt and investment reports for the Board. These reports include information about the bond proceeds portfolio managed by Cutwater and Logan Circle, including book values, market values, maturities, and month-end yields. The reports also include a comparison of the yields and returns against a benchmark provided by OCTA's financial advisor.

Both Cutwater and Logan Circle invoice on a quarterly basis. For Cutwater, the fee is 0.05 percent of the average market value of the cash and securities in the portfolio, excluding balances in local government investment pools. For Logan Circle, the fee is 0.09 percent for balances of \$0 to \$100,000,000, 0.07 percent for balances of \$100,000,000 to \$200,000,000, and 0.05 percent for balances over \$200,000,000. Invoices are reviewed and approved by the Treasurer and processed by Accounts Payable.

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Objectives, Scope and Methodology

The objective was to determine whether the investment managers provide services and invoice in accordance with agreements and to determine whether there is evidence of adequate management oversight and compliance with policies and procedures.

The methodology consisted of reviewing the procurement of investment management services, reviewing contract terms, reviewing management's controls over invoice review and monitoring of investment manager performance, and reviewing invoices paid for contract compliance and evidence of oversight controls.

The scope is limited to compliance with OCTA's procurement policies, contract compliance with Agreement No. C-0-1784 with Logan Circle and Agreement No. C-1-2400 with Cutwater, and internal controls over payment and performance monitoring. The scope includes invoices paid on Agreement Nos. C-0-1784 and C-1-2400, for services from contract inception through December 2012. The scope also includes a haphazard sample of five monthly and one quarterly investment and debt report prepared by Treasury during the period from contract inception through December 2012. The scope excludes contracts with investment managers for the short-term portfolio.

This review was conducted in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Audit Comments, Recommendations and Management Responses

Reporting of Yields and Returns

Investment and debt reports provided to the F&A and Board list the yields and returns achieved by Cutwater and Logan Circle against a customized benchmark provided by OCTA's financial advisor.

Internal Audit tested a sample of monthly and quarterly reports and found several errors. In three instances, reports reflected the prior month benchmark yield rather than the current month. One report reflected a benchmark return of 0.01 percent rather than the correct return of 0.001 percent. On another monthly report and the corresponding quarterly report, the yields of the investment managers were reported at 0.40 percent and 0.35 percent rather than 0.37 percent and 0.39 percent, respectively.

Recommendation 1:

Internal Audit recommends Treasury strengthen controls to help ensure the accuracy of these reports.

Management Response:

The Treasury/Toll Roads Department agrees with the recommendation to strengthen controls for our reporting process. An extra level of review of all reports will be conducted. Currently, preparing monthly and quarterly reports are a manual process. OCTA is implementing a new portfolio management software system that automates downloading of investment information from OCTA's custodian and trustee banks. This automation will eliminate most manual processes.

Board Approval of Indefinite Term Contracts

The agreements with Cutwater and Logan Circle were executed with indefinite contract terms. Procurement policies and procedures do not specifically address indefinite contract terms; however, procedures do require prior concurrence from the Board for any contract term in excess of five years. The staff report requesting authorization to execute agreements for investment management services did not identify the contracts as having indefinite terms; therefore, it is not clear that Board concurrence was obtained.

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Recommendation 2:

Internal Audit recommends management strengthen controls to ensure that Board approval is specifically requested for any contract terms exceeding five years.

Management Response:

Management agrees and will strengthen controls to ensure staff reports request specific Board approval for contract terms greater than five years.