OCTA

*April 26, 2017*

**To:** Finance and Administration Committee

**From:** Darrell Johnson, Chief Executive Officer

Janet Sutter, Executive Director
Internal Audit

**Subject:** Investment Management Service Contracts, Internal Audit Report No. 17-504

## Overview

The Internal Audit Department has completed an audit of Investment Management Service Contracts. Based on the audit, contract compliance and invoice review controls are generally adequate; however, several concerns were identified related to the procurement of treasury management software. Also, a recommendation was made to update agreements with investment managers.

## Recommendation

Direct staff to implement two recommendations provided in Investment Management Service Contracts, Internal Audit Report No. 17-504.

## Background

The Treasury/Public Finance Department (Treasury) is responsible for management of the Orange County Transportation Authority's (OCTA's) investment portfolio. On December 31, 2016, the investment portfolio's book value was approximately $1.48 billion.

In April 2012, Treasury staff entered into an agreement with Clearwater Analytics, a web-based investment portfolio accounting and reporting tool for the purpose of automating the process of monitoring, reconciling, and reporting of the investment portfolio.

OCTA procurement policy and procedures (policies), approved by the Board of Directors (Board), include procurement approval thresholds, guidelines for issuance of requests for proposal (RFP), criteria for evaluating proposals, and rules for the conduct of procurement activities. Among these is a requirement to obtain Board approval for any contract exceeding $250,000, or any amendment exceeding 15 percent of contract value, or $250,000, whichever is less. Guidelines require Contracts Administration and Materials Management (CAMM) administrators to include a cost and price form for bidders to complete as part of their proposal. Changes to the scope of work after issuance of an RFP are typically addressed as addendums to the RFP. Policies state that all contact with proposers during the solicitation, evaluation, negotiation, and award phases must be limited only to CAMM staff. Finally, CAMM generally uses standard contract templates that have been reviewed with legal counsel and risk management to ensure inclusion of appropriate clauses and insurance coverage requirements.

***Discussion***

The procurement process used to acquire treasury management software in 2011, did not comply with all policies. Further, staff issued the original contract and the first amendment to the contract just under the thresholds that would require Board approval. In addition, the Internal Audit Department (Internal Audit) noted several irregularities related to the initial procurement.

Specifically, the original procurement solicited proposals for a six-month term, with a budget of $70,000. Staff eventually issued a five-year, $250,000 contract to one of the proposing firms without amending or reissuing the RFP. Also, the selected firm submitted a proposal that was not in the format dictated by the RFP. Rather than finding the proposal non-responsive, staff developed an estimate of the annual cost for purposes of price comparison. A corresponding calculation and methodology used to arrive at the price estimate was not documented; however, it resulted in the selected firm receiving the highest score under the cost criterion. Finally, documentation on file reflects that the project manager engaged in direct negotiations with the selected firm.

During these direct negotiations, the project manager negotiated a lower contract cost over a five-year term in exchange for allowing the firm to use the OCTA logo for marketing purposes and to allow a case study to be completed within the first year of the contract. Currently, the vendor website includes a testimonial by the project manager.

Documentation on file reflects staff's estimate of the five-year total cost of the contract to be $296,000, with notes outlining a four-year contract for $250,000, and a one-year amendment of 15 percent; however, the contract was ultimately issued for $250,000 for five years. In March 2016, the fourth year of the contract, staff issued an amendment to increase the contract value by 15 percent. This amendment proved to be insufficient, and two months later a second amendment was requested to increase the total maximum obligation to $409,500. The second amendment was presented to the Board for approval, as required.

Internal Audit recommended management ensure compliance with procedures and adequate documentation be prepared and maintained to support methodologies for cost estimates and decisions made regarding acceptance of proposal deviations and reasons for changes to RFP scope that do not result in an amended or reissued RFP. In addition, Internal Audit noted that the value of cost estimates should translate to contract value. Finally, Internal Audit recommended management consider developing a policy with guidelines for the use of OCTA's logo by vendors, staff-provided testimonials, or staff participation in vendor case studies for marketing purposes. Management agreed and indicated that requirements will be re-enforced with staff, and justification for decisions, along with the method for calculating final pricing, will be documented and on file. Management also agreed to consider developing a policy with guidelines for the use of OCTA's logo by vendors, staff-provided testimonials, or staff participation in studies for marketing purposes.

In addition, Internal Audit found that evergreen contracts with State Street Global Advisors, Western Asset Management Company, and J.P. Morgan do not include standard provisions such as insurance requirements, a right to audit clause, and identification of key personnel. Internal Audit recommended management review and update the agreements to include appropriate and applicable contract clauses. Management agreed and indicated that the agreements will be updated.

***Summary***

Internal Audit has completed an audit of Investment Management Service Contracts.

***Attachment***

A. Investment Management Service Contracts, Internal Audit Report No. 17-504

**Prepared by:**

Gabriel Tang
Principal Internal Auditor
714-560-5746

**Approved by:**

Janet Sutter
Executive Director, Internal Audit
714-560-5591

ATTACHMENT A

# ORANGE COUNTY TRANSPORTATION AUTHORITY
# INTERNAL AUDIT DEPARTMENT

OCTA

## Investment Management Service Contracts

## Internal Audit Report No. 17-504

**April 12, 2017**


**Performed by:** Gabriel Tang, CPA, Principal Internal Auditor
Janet Sutter, CIA, Executive Director

**Distributed to:** Andrew Oftelie, Executive Director, Finance and Administration
Kirk Avila, Treasurer
Virginia Abadessa, Director
Rodney Johnson, Deputy Treasurer

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## Conclusion

The Internal Audit Department (Internal Audit) has completed an audit of Investment Management Service Contracts. Based on the audit, contract compliance and invoice review controls are generally adequate; however, Internal Audit identified several concerns related to the procurement of treasury management software. Also, a recommendation was made to update agreements with investment managers.

## Background

The Treasury/Public Finance Department (Treasury) is responsible for management of the Orange County Transportation Authority's (OCTA's) investment portfolio. On December 31, 2016, the investment portfolio's book value was approximately $1.48 billion.

OCTA has agreements with four investment managers, JP Morgan, State Street Global Advisors, Payden & Rygel, and Western Asset Management Company, for administration of the short-term investment portfolio.

In April 2012, Treasury staff entered into an agreement with Clearwater Analytics (Clearwater), a web-based investment portfolio accounting and reporting tool for the purpose of automating the process of monitoring, reconciling, and reporting of the investment portfolio.

In addition, Treasury holds agreements with Sperry Capital for analysis, consultation, and support for financial and investment matters and with Nossaman, Guthner, Knox & Elliot, LLP for bond counsel services.

OCTA procurement policies and procedures, approved by the Board of Directors (Board), include procurement approval thresholds, guidelines for issuance of Requests for Proposal (RFP), criteria for evaluating proposals, and rules for the conduct of procurement activities. Among these is a requirement to obtain Board approval for any contract exceeding $250,000, or any amendment exceeding 15 percent of the contract value, or $250,000, whichever is less. Guidelines require Contracts Administration and Materials Management (CAMM) administrators to include a cost and price form for bidders to complete as part of their proposal. Changes to the scope of work after issuance of an RFP are typically addressed as addendums to the RFP. CAMM policies state that all contact with proposers during the solicitation, evaluation, negotiation, and award phases be limited only to CAMM staff. Finally, CAMM generally uses standard contract templates that have been reviewed with legal counsel and risk management to ensure inclusion of appropriate clauses and insurance coverage requirements.

## Objectives, Scope, and Methodology

The objectives were to assess contract compliance, procurement, and invoice review controls of investment related service contracts.

The scope included review of Agreement No. C-1-3116 with Sperry Capital, Agreement No. C-5-3099 with Nossaman, Guthner, Knox & Elliott, Agreement No. C-1-2926 with Clearwater, Agreement No. C-9-0518 with J.P.Morgan Investment Management Inc., Agreement No. C-9-9302 with Western Asset Management Company, Agreement No. C-7-0145 with State Street Global Advisors, and Agreement No. C-7-0146 with Payden & Rygel. Invoices between July 1, 2014 and December 31, 2016, were tested, except for those of Sperry Capital and Clearwater, as those invoices are reviewed during the semi-annual review of investments. Also, procurements and/or amendments to all contracts since 2011 were reviewed for compliance with policies and procedures.

The methodology included testing for compliance with key contract terms, invoice review policies and procedures, CAMM procurement and amendment procedures.

We conducted this performance audit 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 that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Audit Comments, Recommendations, and Management Responses

### Irregularities Identified in the Procurement of Treasury Management Software

The procurement process used to acquire treasury management software in 2011, did not comply with all OCTA procurement policies and procedures. Further, staff issued the original contract and the first amendment to the contract just under the thresholds that would require Board approval. In addition, Internal Audit noted several irregularities related to the initial procurement.

An RFP was issued in August 2011, requesting firm fixed price bids from qualified firms to provide treasury management software. There was no evidence on file that an Independent Cost Estimate (ICE) was prepared by the project manager as required by OCTA policy and procedures. Further, while the advertised scope of the project was $70,000 for six months, a five year contract for $250,000 was ultimately negotiated and issued. This change to the scope of work could have had an impact on the level of competition had the RFP been amended and/or reissued. The final contract was not executed until eight months after the RFP, in April 2012. Documentation on file suggests that the delay was the result of the project manager encountering difficulties obtaining concurrence from upper management for a longer term contract.

The cost and price form included with the RFP required firms to bid firm fixed prices for individual tasks. On the proposal due date, three bids were received. One was later withdrawn and the remaining two bids were evaluated. One bid reflected a firm fixed price proposal of $70,000, and a second bid proposed a .01 percent fee on portfolio market balances.

While the second proposal was not provided in the format dictated by the RFP, staff did not deem it non-responsive. Instead, staff estimated the cost of the proposal to be $62,771. A corresponding calculation and methodology used to arrive at this amount was not documented; however, it resulted in the selected firm receiving the highest score under the cost criterion.

OCTA policy states that, “All contacts with …consultants that relate to a particular procurement that is in the solicitation, evaluation, negotiations, or award phase must be conducted by CAMM staff.” However, documentation on file reflects direct negotiation occurred between the project manager and the selected firm. The project manager negotiated a lower rate against portfolio market balances over a five year term in exchange for allowing the firm to use the OCTA logo for marketing purposes and to allow a case study to be completed within the first year of the contract. Currently, the vendor website includes a testimonial by OCTA staff. There is no policy governing the use of OCTA’s logo, staff-provided testimonials, or staff participation in vendor case studies for marketing purposes.

A cost estimate of $296,000 was prepared based on the negotiated lower rates and a five-year term, however, the contract was issued for $250,000. A note on the cost estimate outlines a four-year contract for $250,000, and a one-year amendment of 15 percent, terms that would not require Board approval. Ultimately, the contract was issued for $250,000 for five years, through March 2017. In March 2016, the fourth year of the contract, staff issued an amendment to increase the contract value by 15 percent for a total maximum obligation of $287,500. This amendment proved to be insufficient and two months later, the project manager requested a second amendment to increase the total maximum obligation to $409,500. The second amendment was taken to the Board for approval, as required. The accompanying staff report stated that the increase was necessary "…due to continued growth in the size of the OCTA investment portfolio".

**Recommendation 1:**

Management should ensure compliance with OCTA's procurement policies and procedures that require an ICE be prepared and submitted with the requisition and project managers be prevented from conducting direct negotiations with proposing firms.

When a proposal is submitted outside the format dictated by the RFP, decisions to accept the deviation should be documented, along with the calculations and methodologies used when cost estimates are prepared by staff for purposes of comparing price proposals. Documentation on file should describe and justify the reasons for changes to the RFP's period of performance where an amended RFP or a new procurement is not undertaken. The value of the cost estimate on file should translate to the value of the contract issued.

Management should consider developing a policy with guidelines for the use of OCTA's logo by vendors, staff-provided testimonials, or staff participation in vendor case studies for marketing purposes.

**Management Response:**

CAMM agrees to enforce the requirement that an ICE is to be provided by the project manager at the time that the procurement is initiated. This is the current policy and one that staff is aware of. Unfortunately, this contract file did not include an ICE, which is extremely unusual. CAMM management will re-enforce this requirement with the staff during staff meetings and other training exercises. Likewise, CAMM will remind staff that project managers should not be conducting direct negotiations without CAMM staff being present. Negotiations are to be a joint effort of the contract administrator and project manager.

RFP's are issued to solicit an approach, action plan, or technique to solve a problem or need that is described in the RFP's scope of work. At times, a proposal is submitted that offers a different methodology or pricing model than what was originally envisioned when the scope of work and RFP were developed. It is the role of the evaluation committee to review this different approach/pricing model and determine if it has merit and benefit to OCTA, even if it differs from the method identified in the scope of work. If this different approach or pricing model is the one recommended for award by the evaluation committee, it is the contract administrator's duty to document the rationale for this decision. While the contract administrator always prepares a procurement memo that outlines the rationale for the recommendation, it will be important that the contract administrator clearly indicates when a recommendation deviates from the original scope of work and/or RFP and why the proposal was being recommended. CAMM management will ensure that staff understands this requirement and include this justification in the procurement memo. CAMM management will enforce the need for documentation to be included in the file which demonstrates the method for calculating the final pricing as well as how the pricing criteria was scored. Additionally, contracts will be issued consistent with the cost estimate on file. Documentation will be required in the contract file if a contract is issued in an amount that varies greatly from the cost estimate.

Lastly, management agrees to consider developing a policy with guidelines for the use of OCTA's logo by vendors, staff-provided testimonials, or staff participation in vendor case studies for marketing purposes.

## Investment Manager Agreements should be Updated

The State Street Global Advisors, Western Asset Management Company, and J.P. Morgan agreements are evergreen contracts that were initially executed in 1997, 2007, and 2008, respectively. The agreements do not contain standard provisions such as insurance requirements, a right to audit clause, and identification of key personnel.

**Recommendation 2:**

Internal Audit recommends that management review and update the agreements to include appropriate and applicable contract clauses.

**Management Response:**

CAMM agrees to work with Treasury to review the current investment manager agreements and update them to include applicable clauses.