Report of Independent Counsel to SEC: Placement Agent Abuses at Kentucky Retirement System

Findings of Edward Siedle, Esq., Independent Counsel to Christopher Tobe, CFA, Trustee of the Kentucky Retirement System, March 12, 2012

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I. Executive Summary

In August 2010, Christopher Tobe, CFA, CAIA, the sole member of the Board of Trustees of the Kentucky Retirement Systems ("KRS") with expertise in pension investment matters, contacted the United States Securities and Exchange Commission ("SEC"), upon learning of the existence of placement agents involved in certain KRS investments. Mr. Tobe filed a whistleblower complaint and entered into an agreement to voluntarily provide information to the SEC in September 2010.

Later, Mr. Tobe who was the Pension Investment expert for the Kentucky State Auditor ("APA") from 1997-1999, became concerned regarding an APA examination of placement agents at KRS and contacted the Federal Bureau of Investigation (FBI") in May 2011. Mr. Tobe had reason to believe that multiple violations of law had occurred related to

Key Finding:

Trustee Tobe had reason to believe that multiple violations of law had occurred related to certain investments made by KRS, involving the management of $1.3 billion in KRS assets and in excess of $14 million in undisclosed placement agent fees.

certain investments made by KRS, involving the management of $1.3 billion in KRS assets and in excess of $14 million in undisclosed placement agent fees.

At this time, in response to his complaint, the SEC is conducting a formal inquiry into some, or all, of the multiple potential violations of law at KRS complained of by Mr. Tobe.

Mr. Tobe requested independent counsel in connection with the SEC investigation of KRS because, as a whistleblower, he was legitimately concerned that his interests might diverge from the interests of other parties who may have participated in the wrongdoing Mr. Tobe complained of to the SEC and FBI.

It is fair to say that KRS, through its actions, including resisting reimbursement of the cost of Mr. Tobe's independent legal representation, denial of offsite access to KRS financial records and threats to recoup legal reimbursement already paid unless details regarding Mr. Tobe's representation were provided to KRS, has made effective representation of Mr. Tobe far more difficult. Given that Mr. Tobe is seeking to address potential harm related to over $1.3 billion in KRS assets, KRS opposition to his efforts is, in my opinion, unwarranted and irrational.

The role and compensation of placement agents related to alternative investments has become a highly controversial issue in recent years as interest in investing in alternatives has grown. As a result of underfunding and stagnant market returns, public pensions, in particular, have significantly increased their allocations to alternative investments. While use of placement agents is not limited to money managers seeking investment from public pensions, revelations

regarding “pay to play” schemes related to public funds have been widely reported in Illinois, New York, California, Ohio and New Mexico.

This report concludes that the examination of KRS by the APA released in June 2011 included superficial analyses and incorporated certain errors in an earlier KRS Internal Auditor’s draft report relating to placement agents. In my opinion, the APA report is remarkable in its failure to adequately address the most obviously troubling issues surrounding use of placement agents at KRS.

The APA did not investigate the services actually provided by the placement agents and whether the millions in compensation paid by this public pension to such agents bore any relationship to services the agents actually provided, or was excessive.

The APA notes that the use of placement agent fees at KRS was not transparent, but does not address when each of the fees was disclosed, by whom and to whom. In my opinion, the answers to these questions may have legal and regulatory significance.

While the APA report summarily states the “unlike management fees, the investor does not pay the placement agent fees,” it fails to state the obvious, i.e., any investment manager willing to pay an intermediary a significant fee would have willingly accepted a lower fee reduced in the amount of the compensation paid by the manager to the intermediary. Any complete analysis must conclude that the investor does indeed pay the placement agent fee, albeit indirectly.

The APA report incorporates a misstatement included in the prior KRS Internal Audit that certain investments may be unavailable to organizations that ban investment managers that use placement agents. The APA fails to note that KRS consultant, SIS, confirmed that the

investments paying the largest placement agent fees could have obtained without paying any such agents.

By far the most troubling finding in the APA report is that the APA, like the KRS Internal Audit, found no evidence of "pay-to-play at KRS. I have investigated dozens of pay-to-play schemes involving pension consultants and others attempting to influence public pension investment decision-making from Guam to Florida. In my opinion, it is unfathomable that the APA could have recited the facts related to a classic "pay-to-play" scenario in its report and yet concluded none existed. I can only assume that the APA lacked expertise in investigating pension abuses and did not retain a qualified expert to assist in its examination.

The analysis provided in the APA report to support the conclusion that that the payment of placement agent fees by investment managers did not correlate to an increase in the management fees paid by KRS is superficial. Given the historic lack of competitive bidding of investment management contracts at KRS and the millions in undisclosed fees recently discovered, a review of all of the investment management contracts at KRS, including those related to traditional asset classes, should be undertaken. The entire investment management contracting process at KRS appears suspect at this time.

In my opinion, KRS alternative asset investment advisory fees may be inflated and could be reduced saving KRS millions potentially. Additional placement agent fees related to KRS assets may remain undisclosed. I note that following a review of placement agents at CalPERS, the pension was able to negotiate $215 million in fee reductions from alternative asset managers.

Finally, it is my opinion that, at a minimum, KRS should seek to recover the millions in undisclosed placement agent fees paid by KRS' managers from the placements agents and the managers. However, given the over

$1.3 billion in KRS assets potentially involved, investment-related damages well in excess of the placement agent fees discovered to date likely exist and may be recoverable.

II. Introduction

In December 2011, I, Edward Siedle, a former attorney with the Division of Investment Management of the SEC and an expert in money management forensics, was retained by Christopher Tobe, CFA, CAIA, the sole member of the Board of Trustees of the Kentucky Retirement Systems ("KRS") with expertise in pension investment matters, to provide independent legal counsel with respect to certain matters involving KRS.[1]

In August 2010, Mr. Tobe contacted the United States Securities and Exchange Commission ("SEC"), upon learning of the existence of placement agents involved in certain KRS investments and the related fees. Mr. Tobe filed a whistleblower complaint and entered into an agreement to voluntarily provide information to the SEC in September 2010.[2] Later, Mr. Tobe who was the Pension Investment expert for the Kentucky State Auditor ("APA") from 1997-1999, became concerned regarding an APA examination of placement agents at KRS and contacted the Federal Bureau of Investigation (FBI") in May 2011. Mr. Tobe had reason to believe that multiple violations of law had occurred related to certain investments made by KRS, involving the management

[1] I am also a member of the Florida Bar.

[2] SEC Reference, MNY 8389; Whistleblower Complaint TCR1309211467548

of $1.3 billion in KRS assets and in excess of $14 million in undisclosed placement agent fees.

Consistent with his fiduciary duty as a Board member and prior to contacting the SEC and later the FBI, Mr. Tobe informed the KRS Board of his concerns regarding these suspect investments and undisclosed fees. When the Board failed to take (in his opinion) appropriate action, he contacted the SEC and FBI, in order to protect the assets of KRS. As a result, Mr. Tobe is a "whistleblower" who may be afforded certain protections under federal and state law.[3]

At this time, presumably in response to Mr. Tobe's whistleblower complaint, the SEC is conducting an investigation into some, or all, of the multiple potential violations of law complained of by Mr. Tobe, including, but not necessarily limited to, the payment of approximately $14 million in placement agent fees.

The KRS Board (other than Mr. Tobe), as well as certain terminated employees of KRS are represented in connection with the SEC investigation of KRS by the law firm of Reinhart Boerner, Van Deuren ("Reinhart"). It is our understanding that there is no "cap" or limit to the amount KRS is willing to pay Reinhart for such representation.[4] After

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[3]Kentucky Revised Statute 61.645 states that the KRS board of trustees shall include two trustees with "investment experience." The statute specifically states that a chartered financial analyst in good standing as determined by the CFA Institute is considered to possess the requisite expertise. As a CFA charter holder, Mr.Tobe is bound by the CFA Institute Code of Ethics and Standards of Professional Conduct Standard IV(A). This standard states that with respect to whistleblowing, a member's or candidate's personal interests, as well as the interests of his or her employer, are secondary to protecting the integrity of capital markets and the interests of clients. Therefore, circumstances may arise (e.g., when an employer is engaged in illegal or unethical activity) in which members and candidates must act contrary to their employer's interests in order to comply with their duties to the market and clients. CFA Institute Code of Ethics and Standards of Professional Conduct Standard IV(A), pg. 107. http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n2.1

[4] Mr. Tobe has not been provided with invoices or amounts paid by KRS to Reinhart related to such representation. However, according to a February 20, 2012 article in the State-Journal.com, KRS has paid Reinhart and my firm more than $91,000 combined for representing KRS in the SEC's fact-finding investigation,

lengthy and difficult negotiations, KRS approved reimbursement of the cost of Mr. Tobe's independent legal representation only up to $25,000. KRS recently deferred a decision regarding whether to respond to a request to increase reimbursement of the cost of Mr. Tobe's legal representation at its February 16, 2012 meeting. No date was provided by which a decision related to the request would be made.[5]

Mr. Tobe requested independent counsel, as opposed to having the Reinhart firm represent him in connection with the SEC investigation of KRS, for two reasons. First, as a whistleblower, he was legitimately concerned that his interests might diverge from the interests of other parties the firm represented who may have participated in the wrongdoing Mr. Tobe complained of to the SEC and FBI. Second, Mr. Tobe was concerned that since Reinhart had earned hundreds of thousands of dollars providing legal advice to KRS over time, including apparently advice related to the payment of placement agent fees, the firm had a conflict of interest in connection with the SEC investigation.[6]

It is fair to say that KRS, through its actions, including resisting reimbursement of the cost of Mr. Tobe's independent legal representation, denial of offsite access to KRS financial records and threats to recoup legal reimbursement already paid unless details regarding Mr. Tobe's representation were provided to KRS, has made effective representation of Mr. Tobe far more difficult.[7] Given that Mr.

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according to Chief Investment Officer T.J. Carlson. Thus, it, as mentioned below, appears that KRS has paid Reinhart $66,000 for representing the trustees of the fund (other than Tobe), and certain former employees. http://www.state-journal.com/news/article/5159017

[5] Letter from Ryan Stippich, Reinhart to Edward Siedle, February 29, 2012.

[6] During an on-site document review, Mr. Tobe discovered an email dated February 23, 2010 from KRS general counsel to Juss Snellman at Reinhart discussing the use of Glen Sergeon as a placement agent months before the existence of placement agent fees at KRS were disclosed to him and the full board.

[7] Letter from Ryan Stippich, Reinhart to Edward Siedle, February 29, 2012.

Tobe is seeking to address potential harm related to over $1.3 billion in KRS assets, KRS opposition to his efforts is, in my opinion, unwarranted and irrational.

Throughout my investigation I have regularly warned counsel for KRS that I, as Mr. Tobe's legal counsel, had a duty to maintain client confidentiality and would not, under any circumstances, breach that duty by discussing the services I was providing to Mr. Tobe with KRS or its counsel – parties which are clearly hostile to Mr. Tobe. Further, I warned counsel for KRS that it was inappropriate to suggest that KRS reimbursement (or recouping) of the costs of Mr. Tobe's legal representation was conditioned upon my providing KRS and its counsel with confidential information regarding the services I was providing to Mr. Tobe.[8]

Providing KRS and its counsel with information regarding the forensic methodology and direction my representation and related investigation involved would have further undermined my efforts to effectively represent my client and investigate the matters at issue.[9] I advised KRS and its counsel that when my findings were completed, I would provide a copy to them.

On February 1, 2012, I requested that KRS or its counsel provide me with audited financial statements related to an investment KRS had made in an Arrowhawk investment fund. As a leading expert in pension investment management representing a whistleblower in connection with an SEC investigation of placement agent fees, I had determined

[8] See Exhibit A, letter to Ryan Stippich, Esq., Reinhart, February 16, 2012.

[9] Further, as a "whistleblower," alleging potential violations of law, Mr. Tobe may be entitled to certain protections under law and required to maintain confidentiality in order to not undermine regulatory or law enforcement efforts.

that a review of the Arrowhawk financial statements was necessary for the following reasons:

According to an article in Forbes magazine entitled "Secret Agent," the Arrowhawk investment was an area of contention between my client and the then-chairman of the Board.

"Suspicious about the Kentucky fund's management, trustee Tobe began pressing for information on use of placement agents in April 2009. Tobe says that in August of that year he was forced off the investment committee by Randy J. Overstreet, who'd chaired the board for 14 years; the following month Sergeon placed $200 million with Arrowhawk."[10]

The Arrowhawk investment figures prominently in Mr. Tobe's whistleblower complaint to the SEC.

The KRS investment in Arrowhawk was approved at a special called meeting of the Investment Committee on September 29, 2009. The Committee approved an allocation to Arrowhawk by KRS of up to $200 million. Arrowhawk was a start-up hedge fund with no established investment track record and was KRS' first-ever hedge fund investment. As noted in the Forbes article:

"Sergeon is a placement agent. His job is to convince officials at state and local pension funds to hand over slices of their $2.3 trillion in assets to his clients, who seek to manage them for a fee. In 2008 and 2009 Sergeon lined up such work with the $14.6 billion (assets) Kentucky Retirement System on behalf of seven money managers. One that paid Sergeon's firm over $2 million was the Arrowhawk Durable Alpha Fund--**an outfit that couldn't have won over public officials with its track record because it was brand-new** (emphasis added).[11]

[10] http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent.html

[11] http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent_2.html

KRS made a direct investment in Arrowhawk, as opposed to investing though a fund of funds with an established track record, which is generally regarded as a more prudent initial approach to hedge fund investing. More disturbing, the Arrowhawk investment involved the greatest placement fee related to any KRS investment, i.e., a $2 million placement agent fee to Glen Sergeon. According to the KRS staff audit discussed later in this report, Sergeon was the one placement agent who had been involved more frequently than others in KRS investments. Further, KRS staff noted, "The frequent use of one placement agent gives the appearance of preferential treatment."

Arrowhawk announced that it was shutting down its operations in December, 2011, in the midst of the SEC investigation of placement agent fees paid by KRS. While investment management firms may shutter from time-to-time for any number of reasons, it is unusual (and a cause for concern) when a firm does so in the midst of an investigation by a regulator.

Finally, I had reason to believe that Arrowhawk lacked audited financials for all years of operation of the fund. In my experience, public pensions that invest in hedge funds that have with relationships with pension insiders, often fail to be diligent in requiring audited financials. Indeed, while I have been unable to review any Arrowhawk financials (for reasons discussed below), counsel for KRS has informed me that KRS does not possess audited financial statements for all periods, only periodic unaudited statements.[12] This is telling to me.

[12] Letter from Ryan Stippich, Reinhart to Edward Siedle, February 29, 2012.

In my opinion, the multiple "red flags" cited above suggested a review of Arrowhawk's financial statements was required to determine the extent of any potential wrongdoing and possible losses by KRS.[13]

On February 13, 2012, KRS and its legal counsel responded that they had determined that a review of the Arrowhawk financial statements was not "relevant" to my representation of Mr. Tobe.[14] In my opinion, whether KRS, its counsel, or any other party lacking expertise in investment management forensic investigations deemed such a review "relevant," was, irrelevant and, as discussed above, there were compelling reasons to examine the firm's financials.

Apparently in an effort to dissuade me from investigating further, I was told that KRS staff was "actively monitoring the Arrowhawk investments and wind-down and taking all appropriate actions to safe-guard KRS' interests in that process." This gratuitous statement was hardly reassuring, given that the SEC was investigating matters related to Arrowhawk that KRS staff apparently overlooked. Further, given the lack of expertise of KRS and its counsel in investigating such matters, in my opinion having an expert review the Arrowhawk financials could only benefit KRS.

More disturbing, in the February 13th letter, KRS and its counsel indicated that "consistent with KRS' normal practice," KRS was only willing to make "any financial statements it has received from Arrowhawk" available to Mr. Tobe and/or me onsite at KRS' offices.[15] It

[13] Note that I also requested the Arrowhawk financials from Arrowhawk and from the SEC. In light of Arrowhawk's disclosure obligations under the federal securities laws, Arrowhawk's failure, without explanation, to respond to my request for this material financial information, made on behalf of a client of the firm, is especially troubling.

[14] See Exhibit B, letter from Ryan Stippich, Esq., Reinhart, February13, 2012.

[15] This statement regarding KRS "normal practice" appears inconsistent with prior statements made by KRS. Note that in a December 7, 2010 email from Randy Overstreet, then Chairman of the Board at KRS, to Mr. Tobe,

was stated that copies of such financials would not be provided and could not be taken off-site.[16] (Interestingly, KRS failed to indicate whether any such audited financial statements actually existed for all years from inception through the end of 2011.) In my opinion, KRS' policy of restricting its trustees (and their legal representatives) to on-site review of financial statements and other documents related to KRS' billions in assets under management, is contrary to sound fiduciary practice and is a prescription for disaster.[17]

In the 30 years I have been involved with public pensions, I have never encountered such a policy restricting a trustee from fulfilling his fiduciary duty to examine the books and records of the pension. Any trustee seeking to review KRS financial documents would have to spend thousands of hours on-site, presumably taking time off from paid work.[18] Trustees lacking pension investment expertise would require even more time to review the records. Trustees, like Mr. Tobe, who

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responding to a request for documents by Tobe, Overstreet indicated that KRS was denying Tobe access to KRS documents as a reprisal. "Since you have disregarded your fiduciary responsibility to protect confidential information in the past, the Board of Trustees will make the decision on how and what means, if any, this information will be distributed outside of KRS."

[16] This is not the first instance when KRS has denied Mr. Tobe the opportunity to review documents related to the fund's investments off-site and copy such documents. For example, see emails between Mr. Tobe and KRS dated December 14, 2010, February 11, 2011 and December 7, 2010. In the February 11, 2011 email, KRS indicated that it would not send Mr. Tobe a copy of Arrowhawk's Form ADV, Part II. Ironically, this document is required to be provided to clients of investment managers under the Investment Adviser's Act of 1940. An investment adviser who merely makes Form ADV available to clients for viewing at its offices and prohibits copying of the disclosure document, would violate the Investment Advisers Act. Given the volume of documents related to his requests (thousands), limiting Mr. Tobe to on-site review effectively thwarted his efforts to fulfill his fiduciary duty to protect assets of the Fund.

[17] Note that in connection with this matter, KRS has both resisted reimbursing Mr. Tobe for the cost of this independent representation and made the cost of such representation far greater by, among other things, requiring counsel to travel to Kentucky to review the relevant documents. In my opinion, such actions are inconsistent with the best interests of KRS and its participants.

[18] KRS trustees are not paid an annual salary for serving as trustees to the fund and are paid only per Committee or per Board meeting.

request thousands of documents and/or reside in distant communities, would be effectively precluded from fulfilling their fiduciary obligations to protect fund assets. Consulting with experts regarding any questions a trustee might have would be virtually impossible.

In my opinion, KRS policies should facilitate, not impede, trustee performance of fiduciary duties.[19]

III. Controversial Role of Placement Agents

Placement agents are intermediaries or middlemen paid by external investment managers to market and sell their investment products. Placement agent fees are paid directly by money managers and indirectly by investors through higher asset-based fees than would be available absent the compensation arrangement between the manager and the intermediary.

Under the economic theory of disintermediation, removal of the intermediary from the process, i.e., "cutting out the middleman," reduces the cost of the service to the customer. Disintermediation initiated by customers is often the result of high market transparency. Markets lacking transparency often are plagued by undisclosed and dispensable intermediaries.

The federal securities laws generally require that registered investment advisers, when employing the services of third party solicitors, provide the client with a written disclosure document, commonly referred to as a "solicitation agreement," describing the terms of any compensation arrangement between the solicitor and the investment adviser, as well

[19] If KRS consistently follows a policy limiting trustee review of pension documents onsite, then records of the hours each trustee spends reviewing such documents should exist at KRS. A review of the hours KRS trustees actually spend examining records onsite should be undertaken to determine whether or not trustees, consistent with their fiduciary duties, spend any appreciable amount of time examining the financial statements of the funds in which KRS invests.

as “the amount, if any, for the cost of obtaining his account the client will be charged in addition to the advisory fee, and the differential, if any, among clients with respect to the amount or level of advisory fees charged by the investment adviser if such differential is attributable to the existence of any arrangement pursuant to which the investment adviser has agreed to compensate the solicitor for soliciting clients for, or referring clients to, the investment adviser.[20] In summary, the disclosure requirements related to investment advisor third party solicitation arrangements reflect the belief that the investment advisory client should be advised of the existence of the intermediary, the fees paid to the intermediary and whether he is paying a higher fee as a result of the intermediary.

In my experience, the SEC has in certain instances required registered investment managers utilizing undisclosed solicitors to offer the public pension investor involved rescission of the transaction and return of all fees paid. In my opinion, such as response by the SEC is appropriate in this matter.

Alternative assets, such as private equity, hedge fund and real estate investments, by definition lack the transparency and liquidity of traditional, publicly-traded assets. The fees related to managing alternative assets are exponentially higher (2-10 times greater) than traditional asset classes, which permits these managers to pay much higher fees and commissions to intermediaries who raise capital. The arrangements alternative asset managers establish with placement agents to market their services also often lack the transparency common to traditional asset accounts.

The role and compensation of placement agents related to alternative investments has become a highly controversial issue in recent years as interest in investing in alternatives has grown. As a result of

[20] Investment Advisers Act of 1940, Rule 206(4)-3

underfunding and stagnant market returns, public pensions, in particular, have significantly increased their allocations to alternative investments. While use of placement agents is not limited to money managers seeking investment from public pensions, revelations regarding "pay to play" schemes related to public funds have been widely reported in Illinois, New York, California, Ohio and New Mexico.[21]

Placement agents are retained by investment managers to raise capital and are compensated by managers based upon the amount of money they raise. Some placement agents have an exclusive focus on a particular type of investor, such as high net worth individuals, institutional investors or even public pensions. While placement agents and investment managers that retain them may claim that placement agents provide services of value to institutional investors, such as access

[21] According to Forbes, "California began in January requiring placement agents to register as lobbyists, attend ethics training and forsake finder's fees from money managers--a move that has prompted some to declare they'll leave the state. California's move follows a scandal in which former directors of the $231 billion (assets) California Public Employees' Retirement System earned $125 million as placement agents. They did so in part by enriching public officials with under-the-table payments, jobs, a Lake Tahoe condo and by hosting a wedding, a Calpers report states. Some former directors have denied wrongdoing.

New Mexico's fund is the subject of SEC and FBI pay-to-play probes. State officials are seeking to recover potentially tens of millions of dollars lost to kickback schemes. In Illinois the Teachers' Retirement System banned placement agents after three middlemen pleaded guilty in an extortion scheme that steered money from investment managers to public officials.

New York State banned placement agents in 2009 after then attorney general Andrew Cuomo discovered them arranging for money managers to receive state work in exchange for bribes to politicians. The case resulted in $170 million in fines and eight criminal guilty pleas. In April former pension boss and state comptroller Alan Hevesi was sentenced to one to four years in prison for accepting $1 million in gifts for committing $250 million to Markstone Capital Partners, LP." http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent_2.html

to investment funds, the value of such services, if any, is clearly diminished with respect to larger institutional investors.

Virtually all large public pensions employ one or more investment consultants to recommend managers to be hired and monitor the performance of incumbent investment managers. For example, as of June 30, 2010, KRS retained three external investment consultants, who were paid a total of $1.150 million in consulting fees for the year. Investment consultants broadly review investment managers and generally maintain lists of managers that they recommend to pensions, as well as continuously monitor. Institutional investors that retain investment consultants generally seek to avoid payment of placement agent fees by using managers recommended and monitored by their investment consultants. These investors recognize that the services provided by a salesman intermediary are unnecessary, or bear little relationship to the services actually provided.

Further, with respect to public pensions, there is the very real danger of "politicization" of the investment decision-making process whereby hiring decisions are made based upon factors other than the merits of the investments offered, such as the political connections of placement agents that managers have hired to represent them.[22] Such "pay to

[22] See comments of Girard Miller, Senior Strategist at the PFM Group, in Governing Magazine, "Until there are prohibitions on pension marketers making campaign contributions to board members and strict controls on contributions to anybody else involved in pension governance, the trustees can profit from their decisions to hire investment advisors. Requiring them to get a lobbying license almost makes it a laughable exercise unless there are explicit prohibitions embedded in the law. Otherwise the law would become a "license to steal." To my way of thinking, third-party marketers ("placement agents") serve no real public purpose when they lobby individual trustees, the board or its investment committee. In the first place, placement agents don't usually fiddle with small municipal plans. They don't have sufficient assets or sophistication to even consider high-profile investment strategies that are commonly used by the jumbo pension plans. The private-equity and hedge fund firms, for instance, serve only the larger public pension plans. Meanwhile, the large pension plans retain professional consultants to help them screen vendors. So why on earth is it necessary for legitimate and competent investment advisors to a pension fund to hire a mercenary? All they need to do is to get in the door with the investment consultants whose business models require independence -- and cannot survive in this

play" schemes involving placement agents inevitably increase the fees paid to external managers. If a pension, such as KRS, does not solicit competitive bids from investment managers, through Requests for Proposals ("RPFs") or use consultant-recommended managers, the risk of inflated manager fees is heightened.

As noted in a March 2011 Report of the CalPERS Special Review, "the excessive nature of some of the fees paid by CalPERS created an environment in which external managers were willing and able to pay placement agent fees at a level that bore little or no relationship to the services apparently provided by the placement agents. **Moreover, the involvement of placement agents apparently led to pressure to accept external manager fees that may have been higher than they should have been** (emphasis added)."[23]

Reviews regarding the role and compensation of placement agents (whether disclosed or undisclosed) require inquiry into any potential harm to pensions related to managers' use of placement agents. As stated in the CalPERS Special Review:

"… addressing the economic issues raised by placement agent-related activities is essential to making participants and beneficiaries whole for the harm that was previously caused. While CalPERS did not have contracts with the placement agents involved with its external money managers, those external managers did. There was, in our view, at least some obligation on the part of the external managers hiring placement agents to monitor whether the millions of dollars in fees they were paying were, in turn, corrupting internal processes at CalPERS.[24]

business if they sell favors to investment advisors." http://www.governing.com/columns/public-money/Who-Needs-Placement-Agents.html

[23] Report of the CalPERS Special Review, March 2011, Page 42.

[24] Id.

According to the initial findings of the KRS internal audit first disclosed in early August 2010, over $14.6 million in placement agent fees were paid to place over $1.3 billion in alternative assets from 2004 to 2009.

IV. KRS Internal Audit on Use of Placement Agents Deeply Flawed

In August 2010, KRS internal auditors presented a draft audit report dated July 14, 2010 regarding the use of placement agents in the hiring of KRS external investment managers. The audit report, which is deeply flawed, focused on use of placement agents for the period July 1, 2004 through September 30, 2009.

Remarkably, the report does not address whether the millions in placement agent fees were disclosed by placement agents or managers to anyone at KRS (including any staff and/or some or all KRS trustees) and, if so, when. Further, the report does not indicate whether certain parties at KRS may have withheld information regarding placement agent fees from others. Whether these fees were disclosed prior to the internal audit is a potentially critical issue, with legal and regulatory ramifications.[25]

The internal audit report fails to address the fundamental question of what services placement agents provided to managers or KRS that could possibly merit millions in compensation.

[25] According to Forbes, "In Kentucky, where no one has been accused of wrongdoing, even the state fund's trustees were apparently kept in the dark for years about the $13 million in placement agent payments until last year's release of the state auditor's report… In April the Kentucky board fired longtime director Michael Burnside amid concerns that he'd withheld information on placement agents from trustees."
http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent.html

The report does not mention that there were public allegations of "pay to play" related to at least two firms involved at KRS, Diamond Edge and Horsley Bridge Partners.[26]

In its conclusion, the report noted that the increase in alternative asset class investing by KRS had resulted in an increase in the involvement of placement agents. It is stated in the conclusion that private equity investments "often times *require* (emphasis added) use of placement agents in the hiring of new investment managers/general partners." There is no authority cited for the statement that private equity investments *require* the use of placement agents and, in fact, the statement is incorrect.

Use of placement agents in connection with private equity investments is neither required nor universal and is highly controversial, as mentioned earlier, at least with respect to public funds.[27]

Later in the report, it is correctly stated that investments in private equity *frequently* involve (emphasis added) a placement agent and that placement agents are *often times* involved with the acquisition of alternative investments (emphasis added). While these statements are true, large sophisticated pensions with external investment consultants may prohibit the payment of placement agent fees related to their accounts, in recognition of the fact that such fees may be corrupt the investment decision-making process and add to overall costs.[28]

[26] http://www.dnainfo.com/20100528/manhattan/kenneth-starr-scandal-whos-who-guide, http://tpmmuckraker.talkingpointsmemo.com/2009/05/do_pension_scandals_date_back_to_the_lincoln_bedro.php

[27] Calpers Report Takes Aim at Private Equity Middlemen, New York Times, March15, 2011.

[28] "In Illinois the Teachers' Retirement System banned placement agents…" http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent_2.html

As noted in the report, KRS retains two alternative asset investment consultants, R.V. Kuhn and SIS, with demonstrable expertise in alternative investing. Either of these firms is clearly capable of identifying alternative investments worthy of funding by KRS and it is a simple matter for investment managers interested in managing KRS assets to contact either KRS or its investment consultants. Thus, it is difficult to imagine what value, if any, a placement agent could add to the alternative investment decision-making process at KRS.[29]

The conclusion also states:"There has been one placement agent who has been involved more frequently than others. The frequent use of one placement agent gives the appearance of preferential treatment; however, based upon the audit test performed, no evidence was discovered that would indicate impropriety."

It is unclear what audit test was performed and it is difficult to imagine how, given even the limited facts stated in the report, "no evidence of impropriety" could have been concluded. In my opinion, **ample** evidence of impropriety is referenced in the report. After all, millions in undisclosed fees were paid by this public pension to intermediaries for doing virtually nothing.

The fact that one placement agent was involved in 6 investments by KRS, involving $5.8 million in placement agent fees related to $450 million in KRS assets, within a 19- month period, is a significant "red flag."

Later in the report it is stated that "Mr. Glen Sergeon has provided services to General Partners representing three different business

[29] I note that KRS pays its investment consultants approximately $1.15 million annually whereas the placements agents were promised over $14 million in compensation related to KRS's investments. These millions could have been saved by KRS—had KRS known and asked about any placement agent fees, the managers disclosed the proposed fees to KRS and KRS had objected.

names,"[30] and that "interviews with R.V. Kuhns and SIS, KRS external investment consultants, indicated that this was an unusual practice." Another red flag.

Further, with respect to Vista Equity, the report indicates that the firm misrepresented to KRS the placement agent representing Diamond Edge Capital Partners involved and that Sergeon was the agent, not Marvin Rosen. Another red flag.

The report states that the placement agent fee paid to Camelot Acquisitions Secondary Opportunities Group, LLC, 3% of the amount invested, was higher than the average 1-2%. While the placement agent (Sergeon) defended the higher fee, KRS' consultant (SIS) stated any fee over 2% would be considered unusual. Another red flag.

Further, the report states that Sergeon made known in an interview that the Chief Investment Officer of KRS and he had worked together on a global emerging market strategy when the CIO was employed with the Public Employer of Pennsylvania.[31] According to Forbes, the CIO resigned three weeks before it was revealed that Arrowhawk and other money managers had paid Sergeon millions.[32] More red flags.

It is stated that "due to this prior working relationship and the continuous use of Mr. Sergeon, there could be a perceived appearance

[30] Sergeon was associated with three different placement agent firms through which he earned compensation related to 6 investments made by KRS.

[31] Adam Tosh, the former CIO of KRS referred to, prior to KRS was a fixed income strategist at the Pittsburgh-based money management firm, MDL Capital Management. The founder of MDL was sentenced to 12 years in prison for making risky investments in a hedge fund that lost $216 million from the Ohio Bureau of Workers' Compensation. The internal audit report does not mention Tosh's immediate prior employment at MDL and whether Sergeon had worked with Tosh while at MDL. http://www.toledoblade.com/State/2008/07/08/Mark-Lay-gets-12-years-in-prison-in-Ohio-fraud-case.html

[32] http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent_3.html

of preferential treatment." In the related recommendation it is stated that "while the KRS Placement Agent Policy does not address how frequently a placement agent can be used, the Investment Staff and Investment Committee should strive to be sensitive to the public perception of the frequent use of one Placement Agent."

While the "perceived appearance of preferential treatment" and "public perception" both are matters which may be of legitimate concern to KRS, the critical issue of the extent to which placement agent fees may have undermined the integrity of the investment decision-making process at KRS was not adequately investigated, in my opinion.

The KRS internal audit report also states that "KRS has no control over the fees paid to the placement agent. Placement agent fees are defined by the contract between the placement agent and General Partner/Investment Manager." There is no authority cited for the statement that KRS has no control over the fees paid to the placement agent and, in fact, the statement is incorrect.[33]

As a significant institutional investor, KRS can, by contract, prohibit any investment manager retained by the fund from paying any placement agent fees related to any KRS assets managed by the manager. Further, any request for proposals ("RFP") related to an asset manager proposed contract may include a provision that the prospective manager represents that no placement agent is involved with respect to the bid.[34]

[33] See earlier reference to Illinois Teachers pension banning use of placement agents. The KRS internal audit report notes that Government Finance Officers Associations (GFOA) Best Practices recommend that fiduciaries be careful about transactions that involve placement agents and ensure that the fees paid to the agents are appropriate. If public pensions had no control over such placement agent fees, as the KRS internal audit report states, then there would be no point in the GFOA Best Practice cited.

[34] Note that, contrary to prudent investment practices for public pensions, KRS does not utilize RFPs seeking competitive bids from prospective money managers. Failure to solicit bids undermines the integrity of public pension contracting. RFPs ensure that contracts for investment management services are competitively bid and that requirements related to such contracts are clearly and publicly stated.

The report of the internal audit on use of placement agents was not approved by the KRS Board of Trustees and was sent back to the KRS Audit Committee for due to profound concerns regarding the internal audit process and the resulting draft report. The concerns expressed at the full KRS Board meeting and the subsequent Audit Committee meeting included the following:

- The audit process was conducted without full disclosure to the Board and the Audit Committee;
- The audit process may have been influenced by outside sources;
- Information found during the audit was withheld from some trustees;
- The release of the audit may have been purposely delayed; and
- The internal audit did not fully explore certain issues.[35]

During the September 2010 meeting of the Audit Committee, committee members voted to ask the Auditor of Public Accounts of the State of Kentucky to examine the use of placement agents at KRS, as opposed to having KRS internal audit staff perform additional audit procedures.

V. SEC "Informal" Inquiry

In a letter dated September 9, 2010, the SEC advised Schuyler Olt, General Counsel of the KRS (at that time), that the SEC was conducting an informal inquiry into the KRS. Olt was asked to voluntarily provide the SEC with certain documents related to an audit concerning placement agents at KRS; any agreements or contracts relating to placement agent payments made in connection with investments by KRS; any minutes of the Board of Trustees or its committees, including the Investment

[35] Auditor of Public Accounts Report, page 50.

Committee, in which placement agent payment or disclosure of placement agents was discussed. The letter stated that this was an informal, non-public inquiry and that it should not be construed as an indication by the SEC that any violation of law had occurred nor should it be considered as a reflection upon any person, entity or security. No subpoena was included with the letter.

A document entitled Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena indicates that the SEC's principal purpose in soliciting the information was to gather facts in order to determine whether any person violated, is violating, or is about to violate any provisions of the federal securities laws or rules for which the SEC had enforcement authority. However, it is noted that facts developed may constitute violations of other laws or rules and that the SEC often makes its files available to other governmental agencies, particularly United States Attorneys and state prosecutors. Whether or not the SEC makes its files available to such agencies is, in general, a confidential matter between the SEC and such other governmental agencies.

VI. SEC Formal Inquiry and Subpoena

In a letter dated November 18, 2010, the SEC notified Olt that it was conducting an inquiry (no longer termed an "informal" inquiry) of KRS and enclosed a subpoena that had been issued to KRS in connection with the matter. The attachment to the subpoena included the previous document requests made by the SEC staff on September 9, 2010, i.e., the informal, voluntary requests. The letter indicated that it appeared to the staff of the SEC that KRS had produced documents responsive to the September 9th request and that, with some exception, it might not be necessary to produce additional documents responsive to the previous

requests. The letter noted that this was a non-public, fact-finding inquiry and that the SEC was trying to determine whether there had been any violations of the federal securities laws.

A list of 16 additional documents were requested by the SEC, including documents related to KRS's internal audit of placement agents; documents related to meetings between KRS employees, trustees or consultants concerning investments by KRS that involved placement agents; documents related to any KRS policy or practice respecting placement agents or their disclosure and any violation of any such policy; documents concerning the placement agent policy adopted by KRS in August 2009; documents concerning expenses incurred by KRS employees, trustees or consultants in connection with certain investments; documents concerning any gifts received from or returned to investment managers or advisers or persons acting on their behalf by KRS employees, trustees or consultants; documents related to communications with Glen Sergeon Jr. (a placement agent); documents concerning the departure from KRS of Adam Tosh, the fund's former Chief Investment Officer.

According to a December 6, 2010 memorandum from Olt to Mike Burnside, on December 3, 2010, KRS forwarded several thousand documents to the SEC in response to the subpoena dated November 16, 2010. (Recall that Burnside was the longtime director of KRS who, according to Forbes, had been fired by the board amid concerns that he'd withheld information on placement agents from trustees.)

VII. Auditor of Public Accounts Analysis Superficial and Incorporates Errors in KRS Internal Audit

On June 28, 2011, the Auditor of Public Accounts ("APA") completed an examination of certain controls and management practices of the KRS. This examination included a review of the KRS Internal Auditor's draft report relating to placement agents.

The APA report is remarkable in its failure to adequately address the most obviously troubling issues surrounding use of placement agents at KRS. For example, the APA did not investigate the services actually provided by the placement agents and whether the millions in compensation paid by this public pension to such agents bore any relationship to services the agents actually provided, or was excessive. If the services provided were minimal and the fees were excessive, then the payment of such fees by KRS investment managers is indefensible.

The APA notes that the use of placement agent fees at KRS was not transparent,[36] but does not address when each of the fees was disclosed, by whom and to whom. Were the placement agent fees disclosed in contracts between KRS and the investment managers? Were the fees disclosed to some or all KRS staff or trustees prior to 2010? The answers to these questions may have legal and regulatory significance.

While the APA report summarily states the "unlike management fees, the investor does not pay the placement agent fees,"[37] it fails to state the obvious, i.e., any investment manager willing to pay an intermediary a significant fee would have willingly accepted a lower fee reduced in the amount of the compensation paid by the manager to the

[36] Page 32.

[37] Page 34.

intermediary. Any complete analysis must conclude that the investor does indeed pay the placement agent fee, albeit indirectly.

The APA report states, “It was also determined that the payment of placement agent fees by investment managers did not correlate to an increase in the management fees paid by KRS or reduce the funds available to pay benefits to retirees.” However, the analysis provided to support these conclusions is superficial and relies upon data from a conflicted source, i.e., KRS staff. Given KRS staff’s proven lack of sophistication regarding placement agent arrangements, there is no assurance that, even at this time, all placement agent arrangements involving KRS investment managers have been ferreted out. The APA apparently made no effort to independently verify that all KRS investment managers had disclosed all placement agent arrangements involving KRS assets. This omission is significant because any comparison of investment advisory fees involving disclosed placement agents with fees potentially involving undisclosed placement agents is worthless. **In my opinion, additional placement agent fees related to KRS assets may remain undisclosed.**

Further, a finding that the investment management fees at KRS are comparable (regardless of presence or absence of placement agent involvement), may indicate that all of the investment management fees have been inflated. Given the lack of competitive bidding of investment management contracts at KRS through an RFP process and the undisclosed fees paid to intermediaries recently discovered, a review of all of the investment management contracts at KRS, including those related to traditional asset classes, should be undertaken. The entire investment management contracting process at KRS appears suspect at this time.

Investigations into the investment management fees plan sponsors pay are difficult with respect to even traditional assets classes. With respect to alternative assets, there are major different types of assets and strategies and far less transparency regarding fees. Reviews of investment advisory fees my firm has undertaken on behalf of plans reveal that there are significant differences between "published" fees and the fees plans actually pay.[38] Not surprising, the greatest fee discounts are available to the largest investors – state public pensions such as KRS.

In summary, the APA, either unaware of, or unconcerned with, the nuances involved in reviewing investment advisory fees, has not demonstrated that the payment of placement agent fees by investment managers at KRS did not correlate to an increase in the management fees paid by KRS.

In my opinion, KRS alternative asset investment advisory fees may be inflated and likely could be reduced. Note that following a review of placement agents at CalPERS, the pension was able to negotiate $215 million in fee reductions from alternative asset managers.[39]

In support of the use of placement agents, the APA report repeats a misstatement included in the KRS Internal Audit. The report states that "Certain investments may be unavailable to organizations that decide to ban investment managers that use placement agents."[40] There is no

[38] See Examining Active Investment Advisory Fees: 2003 "Actual" Fee Survey of 100 Pensions, Edward Siedle, Benchmark Financial Services, August 2003. "Institutional clients typically pay 10-15% less than investment managers' "published" fees for accounts less than $75 million. Thus, "published" fee data is of limited utility to plans seeking guidance regarding appropriate fee levels."

[39] CalPERS big legal bill raises eyebrows, Los Angeles Times, June 28, 2011.

[40] Page 32.

authority cited for this statement and, in fact, the statement is incorrect. There is no reason to believe (and I have never found it to be the case) that asset managers decline to manage assets for large investors who refuse to permit them to pay placement agents. Further, the APA fails to note that KRS consultant, SIS, confirmed in a public meeting of the KRS Audit Committee held August 2010, that the investments paying the largest placement agent fees could have obtained without paying any such agents.[41] **In my opinion, at a minimum, KRS should seek to recover any undisclosed placement agent fees paid by KRS' managers from the placements agents and the managers. However, investment-related damages well in excess of the placement agent fees discovered to date likely exist and may be recoverable.**

By far the most troubling finding in the APA report is that the APA, like the KRS Internal Audit, found no evidence of "pay-to-play at KRS.[42]

The APA report provides extensive information regarding meetings a placement agent scheduled for the former KRS CIO with investment managers seeking to manage KRS assets. At these meetings the placement agent acted as a "gatekeeper" or consultant to KRS. To be considered by KRS (i.e., to "play"), managers understood that they had to pay the placement agent (who had an obviously strong relationship with the KRS CIO) a fee.[43]

[41] Mr. Tobe, who was present at the meeting, requested in an email dated September 1, 2010 that the minutes of the meeting of the August Audit Committee reflect statements by SIS indicating that placement agent fees were unnecessary for the Arrowhawk and Blackstone investments.

[42] Page 33

[43] The APA notes that the placement agent said he removed one of the managers from the schedule because "they got difficult." However, the APA report does not indicate any effort was made to identify the manager and find out the facts surrounding the incident. In "pay-to-play" investigations involving public pensions, it is common for principled investment managers, sensing potential illegalities, to refuse to participate in the schemes. Such managers are often eager to provide information to investigators since they were unfairly excluded from contracting opportunities.

Pay-to-play exists where investment managers pay compensation to parties in an attempt to influence the hiring of investment managers for the pension. Whether the party in receipt of the compensation from the investment managers seeking to be retained is a fiduciary to the fund or an elected public official, is irrelevant. All that matters is that the party in receipt of the compensation has an ability to influence hiring and, through his actions, the integrity of the investment decision-making process of the pension has been corrupted.

For example, in two unprecedented and related investigations, beginning in 2001, I advised the Metropolitan Government of Nashville and Davidson County and the City of Chattanooga regarding pay-to-play schemes involving the investment consultant to their $2 billion and $120 million, respectively, public pensions. The investment consultant/ gatekeeper to these pensions, who maintained in litigation that he was not a fiduciary to the funds, earned significant undisclosed compensation from the investment managers he recommended to the pensions. The two pensions later successfully recovered a total of approximately $16 million and, in 2009 the SEC took public administrative and cease and desist action.[44]

In 2006, the City of San Diego and Callan Associates, the investment consultant to the City's pension entered into a $4.5 million settlement of a case alleging a pay-to-play scheme involving the pension's investment managers and Callan.[45]

Since then, I have investigated dozens of other pay-to-play schemes resulting in litigation involving pension consultants and others attempting to influence public pension investment decision-making from Guam to Florida.

[44] http://www.sec.gov/litigation/admin/2009/34-60344-o.pdf

[45] https://www.sdcers.org//boardagendas/tab_15_0107.pdf

In summary, in my opinion, it is unfathomable that the APA could have recited the facts related to a classic “pay-to-play” scenario and yet concluded none existed. I can only assume that the APA lacked expertise in investigating pension abuses and did not retain a qualified expert to assist in its examination.

Fortunately, the audit report was referred to the SEC to determine whether further investigation is warranted and the SEC agrees that, at a minimum, further investigation of Mr. Tobe’s allegations of potential wrongdoing related to KRS is warranted.

About Edward Siedle

Edward Siedle is the founder of Benchmark Financial Services, Inc., a firm which provides “enhanced integrity” investment management fiduciary consulting and forensic investigative services to institutions, law enforcement, regulators and wealthy individuals. "Enhanced integrity" refers to the proprietary heightened due diligence and monitoring methodology that the Company utilizes to reduce risk and increase returns. The firm has pioneered the emerging field of forensic investigations of the money management industry and has conducted investigations worldwide involving in excess of $1 trillion in assets under management.

The media has referred to Siedle as "the Sam Spade of Money Management," “the Financial Watchdog” and "the Pension Detective." He began his career in law with the SEC's Division of Investment Management, which regulates money managers and mutual funds; he later served as Legal Counsel and Director of Compliance to Putnam Investments, one of the largest international money management firms. Since 1989, Siedle has founded and managed firms offering specialized services to municipalities, pension funds and money managers.

He is nationally recognized as an authority on investment management and securities matters. He has testified before the Senate Banking

Committee regarding the mutual fund scandals and the Louisiana State Legislature regarding pension consultant conflicts of interest. He was a testifying expert in various Madoff litigations. Articles about him have appeared in publications including Time, BusinessWeek, Wall Street Journal, The New York Times, Barron's, Forbes, the Boston Globe, and Institutional Investor. He widely lectures and has appeared on CNBC, Fox Business News, Wall Street Week, and Bloomberg News. He writes a "Financial Watchdog" column for forbes.com. Siedle is an active member of the Florida Bar and a retired member of the Massachusetts Bar.