North Carolina Pension's Secretive Alternative Investment Gamble: A Sole Fiduciary's Failed "Experiment"

Forensic Investigation of the Teachers' and State Employees' Retirement System of the State of North Carolina for the State Employees Association of North Carolina, SEIU Local 2008 by Benchmark Financial Services, Inc., April 17, 2014

North Carolina Pension's Secretive Alternative Investment Gamble: A Sole Fiduciary's Failed "Experiment"

Executive Summary

Janet Cowell is neither the first North Carolina State Treasurer to abuse her power as sole fiduciary of the state pension nor, absent radical structural reform, will she be the last. Pay-for-play has long been a problem in the state's pension system. For more than a decade state treasurers have handed out billions of dollars in public assets to money management and other firms that contribute to their political campaigns.

Cowell has taken this *quid pro quo* to a new level as the Teachers' and State Employees' Retirement System of the State of North Carolina ("TSERS") has grown to $87 billion and disclosed fees paid to Wall Street have skyrocketed 1,000 percent. Cowell's political manipulation of the state pension fund has cost North Carolina **$6.8 billion** in fees and lost investment opportunities during her tenure.

The unchecked ability to steer tens of billions in workers' retirement savings into hundreds of the highest-cost hedge, private equity, venture and real

Key Finding:

Treasurer Cowell's political manipulation of the state pension fund has cost North Carolina $6.8 billion in fees and lost investment opportunities during her tenure.

estate funds ever devised by Wall Street, in exchange for political contributions to her campaign and to the campaigns of other influential politicians, makes the Treasurer today arguably the state's most powerful elected official.

The profound lack of transparency related to these risky so-called "alternative" investments provides investment managers ample opportunities to charge excessive fees, carry out transactions on behalf of the pension on unfavorable terms, misuse assets, or even steal them outright. Worse still, the Treasurer has betrayed her fiduciary duty by entering into expansive agreements with Wall Street to keep the very details of their abuse of pension assets secret — including withholding information regarding grave potential violations of law.

Kickbacks, self-dealing, fraud, tax evasion and outright theft may be designated as confidential pursuant to the North Carolina Trade Secrets Protection Act, says the Treasurer.

On a more granular level, Cowell's efforts to thwart disclosure have helped mask potential violations including, but not limited to the following: fraudulent representations related to the performance of alternative investments; concealment and intentional understatement of $400 million in annual alternative investment fees and expenses to date; concealment of approximately $180 million in placement agent compensation; the charging of bogus private equity fees; violations of securities broker-dealer registration requirements related to private equity transaction fees; securities and tax law violations regarding investment management fee waivers and monitoring fees; self-dealing involving alternative investment managers; mystery investor liquidity and information preferences, amounting to licenses to steal from TSERS; pension investment consultant conflicts of interest; predatory lending and life settlement related fraud.

Further, the Treasurer has invested billions of dollars of pension assets in North Carolina private equity funds and companies via an initiative with dubious economic prospects and which has the markings of political influence-peddling.

In our opinion, billions in TSERS investments can only be explained by the improper collateral benefits they provide to the Treasurer — as opposed to any supposed investment merit.

Absent reform, corruption of TSERS is likely to cost the state's public workers and taxpayers billions more over the next few years and leave in place a system under which Cowell's successors will compound the financial damage.

The need for regulatory intervention by the United States Securities and Exchange Commission ("SEC") in the North Carolina state pension alternative investment stand-off between the Treasurer and her deep-pocketed Wall Street allies, on the one hand, and the stakeholders committed to safeguarding the pension, on the other, cannot be overstated.[1] The same situation exists at countless other public pensions around the nation, in states such as Illinois, Kentucky, Rhode Island and South Carolina.

At stake is nothing less than the fiscal viability of state and local governments across the country, as well as state employees' retirement security.

---

[1] We note that this month the SEC confirmed that, according to an internal review, more than half of about 400 private equity firms that the agency examined charged "bogus" fees and expenses without notifying investors. "These organizations, though, are opaque, and that's the problem. We're basically taking them at their word," said William Atwood, executive director of the Illinois State Board of Investment, which oversees three state retirement systems. "The role of the regulator in this situation can't be overstated." http://mobile.bloomberg.com/news/2014-04-07/bogus-private-equity-fees-said-found-at-200-firms-by-sec.html

Today, TSERS assets are directly invested in approximately 300 funds and indirectly in hundreds more underlying funds (through fund of funds), the names, investment practices, portfolio holdings, investment performances, fees, expenses, regulation, trading and custodian banking arrangements of which are largely unknown to stakeholders, the State Auditor and, indeed, to even the Treasurer and her staff.

As a result of the lack of transparency and accountability at TSERS, it is virtually impossible for stakeholders to know the answers to questions as fundamental as who is managing the money, what is it invested in and where is it?

It is indisputable that TSERS' disclosed investment management costs alone (i.e., not including the enormous hidden costs revealed in this report) have skyrocketed in recent years and are projected by the Treasurer to steeply climb. Investment risk has grown to a record crisis level. Performance of hedge funds, private equity and real estate alternative investments has been beyond bad — horrific — for over a decade.[2] Pay-for-play and transparency reforms promised by the Treasurer have failed, year after year, to materialize — despite multiple costly expert reviews paid for by the pension.

Worse still, the Treasurer has refused to comply with a new state law, which specifically requires full disclosure of all direct and indirect pension investment management and placement agent fees.[3]

---

[2] According to pension consultant Cliffwater LLC, for the ten years ending June 30, 2011, for 23 reporting pensions, TSERS ranked 21 — underperforming the State Fund Real Estate Average of 6.7 percent by a massive 4 percent. For the ten years ending June 30, 2011, for 23 reporting pensions, TSERS ranked 23 — hugely below the Private Equity Average of 9.3 percent by more than 7 percent. As of June 30, 2013, hedge, private equity and real estate 10-year performance remains glaringly below even the more-forgiving custom benchmarks the Treasurer uses to measure performance.

[3] NCGS 147-69.2(b)(10a).

Benchmark Financial Services, Inc. (“Benchmark”) was retained by the State Employees Association of North Carolina, SEIU Local 2008 (“SEANC”), to provide a preliminary expert forensic review of TSERS.

SEANC is the South’s leading public employees association comprised of 55,000 state employees and retirees. SEANC members have a vested interest in the state retirement system as the primary and most consistent contributors to it. Each month state employees contribute 6 percent of their paychecks into the retirement system.

In this preliminary investigation Benchmark identified widespread potential violations of law within the TSERS investment portfolio. It is our view that these concerns should be investigated by the SEC, Internal Revenue Service (“IRS”) and law enforcement.

Treasurer’s Lack of Transparency

Forensic investigations of pensions require access to evidence. Contrary to initial public statements by the Treasurer indicating a willingness to cooperate with our investigation, she has made conducting this review of potential violations of law on behalf of TSERS stakeholders far more difficult by withholding the overwhelming majority of the information we requested.

Throughout her tenure, the Treasurer has stated repeatedly in public that she is committed to transparency. In contrast, she has proved unwilling to disclose to the public even the minimum pension information required under state law. Further, her office has, in our opinion, released information regarding TSERS to the public that has often been left intentionally incomplete and made deliberately misleading.

It is also notable that the Treasurer has failed to disclose certain significant investment manager fee and performance data that even her oft-criticized predecessor, Richard Moore, had voluntarily provided.

All of the financial information we requested in connection with this investigation was readily available to Cowell and her staff and of obvious materiality to TSERS participants, taxpayers and investors.

Perhaps most disturbing, in response to our specific requests the Treasurer refused to disclose offering memorandum and other key documents (including information regarding millions in placement agent fees) related to TSERS' costly, high-risk alternative investments, citing supposed "trade secret" concerns raised by the alternative managers.

Viewed from a regulatory and public policy perspective, the Treasurer's practice of withholding relevant information and intentionally providing incomplete or inaccurate disclosures regarding TSERS investments results in: (1) concealing potential violations of state and federal laws, such as those detailed throughout this report; (2) misleading the public as to fundamental investment matters, such as the true costs, risks, practices and investment performance related to hedge, private equity, venture and real estate alternative investment funds; (3) understating the costs and risks related to TSERS investments specifically; (4) misrepresenting the investment performance and financial condition of the state pension to investors in state obligations.

As stated on the website of the SEC:

"The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely,

comprehensive, and accurate information can people make sound investment decisions."

On the other hand, when state officials and pension funds, such as the Treasurer and TSERS, intentionally withhold or misrepresent basic facts regarding investments material to evaluating investments, the pool of knowledge all investors can rely upon becomes contaminated.

In our opinion, there is simply no reason participants in TSERS who rely upon the investment decisions made by the Treasurer for their retirement security, and other stakeholders, should be provided with unreliable investment information — afforded less protection under the state and federal securities laws — than investors in shares of public companies and mutual funds.

Nation's Seventh Largest Public Pension Has No Audited Financials

Remarkably, there are no audited financial statements for TSERS, the seventh largest public pension in the nation. We are unaware of any other public pension that completely lacks financial statements audited by either an independent accounting firm or the State Auditor, or both. This represents a major material weakness in the State of North Carolina Comprehensive Annual Financial Report ("CAFR") which is relied upon by ratings agencies, municipal bond holders and the federal government in providing assistance to states.

In our opinion the lack of audited financial statements for TSERS is indefensible. The limited financial information regarding TSERS which the State Auditor claims to have audited and which is included in the voluminous 300-page CAFR, is of minimal value and is almost certainly incomprehensible to stakeholders.

We found no evidence in the CAFR or elsewhere to suggest that the Treasurer or State Auditor is even aware of the myriad new risks facing

TSERS, much less begun to focus upon the emerging critical issues related to alternative investments.

In our opinion, a stand-alone audit of TSERS which would improve oversight and management of pension investments, reveal deficiencies (including fraud and other malfeasance), and produce savings exponentially greater than any limited audit cost, is decades overdue.

Notably, Treasurer Cowell has expressed the opposite view, stating that a separate audit of TSERS would be cost-prohibitive.[4]

We find this assertion to be absurd and recommend that the scope of any future stand-alone audit include responses to the specific stakeholder concerns we have identified in this report.

Treasurer's Government Operations Reports Violate State Law

As required under relevant law, on a quarterly basis the Treasurer provides a report to the Joint Legislative Commission on Government Operations on the investment activities of the State Treasurer, including TSERS.

In our opinion, given the disorganization, misstatements and omissions therein, there is simply no way that the Joint Legislative Commission on Government Operations, or anyone else for that matter, could possibly monitor or evaluate TSERS investment activity and performance from the information included in these reports.

The incomplete performance information provided in the discussion and other sections in the Government Operations reports results in

[4] N.C. pension investigator 'disturbed' by fund's audit practices, Triangle Business News, January 23, 2014.

concealing significant underperformance against the relevant indexes that would be readily apparent if complete performance information were provided in the initial narrative section.

Effective August 2013, state law[5] mandates full disclosure of all direct and indirect investment management and placement agent fees in the Treasurer's Government Operations reports. Cowell has failed to supplement the Government Operations reports with the newly required information.

In connection with our forensic investigation, on March 17, 2014, we reported the Treasurer's violations of this law to State Auditor Beth Wood and asked that her office immediately investigate.

A History of Pay-for-Play Abuses

Allegations of improper pay-for-play payments by money managers and other vendors retained by TSERS first emerged in 2005 and were the subject of an early 2007 Forbes article titled "Pensions, Pols, Payola."[6]

In 2009, the state's chief pension investment officer was reportedly terminated for soliciting donations on behalf of a local charity. In 2012, campaign donations to Cowell from plaintiff class action and other law firms retained by TSERS surfaced.

Further, recent disclosures by the Treasurer confirm that at least since 2002, TSERS investment managers have been involved in another form of pay-for-play, i.e., paying tens of millions in compensation to influential secret placement agents that may not be properly registered under the federal securities laws.

[5] Id.

[6] [6] Forbes, February 23, 2007.

The identity of all of the placement agents, their registration status and the amounts of the compensation paid, while known to the Treasurer, remain undisclosed to this day — despite repeated recommendations from investment and legal experts retained by the Treasurer to fully disclose them, and in violation of the new state law which mandates disclosure.

As discussed further below, we estimate a staggering **$180 million** in avoidable fees has been secretly squandered in payments to dispensable intermediaries for conflicted, unreliable investment advice.

Flawed Sole Fiduciary Governance Structure

The Treasurer is the sole fiduciary of TSERS funds. Along with Connecticut, Michigan, and New York, North Carolina is one of only four states with a "sole fiduciary" model for managing its public pensions.

All other states vest the fiduciary duty to oversee their retirement assets in a committee generally consisting of worker and retiree representatives, state officials and appointed members of the public, as opposed to a single individual.

There is longstanding, broad national consensus that the sole fiduciary structure is deeply flawed.

In January 2014, the Treasurer announced the creation of a supposedly independent, bipartisan commission (consisting of members hand-picked by her) to review the state's governance structure for investment management. The Treasurer has retained the consulting firm of Hewitt EnnisKnupp-an Aon Company to provide supposedly independent, objective advice to the commission.[7]

---

[7] Based upon our prior investigations of the Aon and Hewitt corporate organization on behalf of the State of Alabama and the U.S. Airways Pilots' Association (as well as published reports regarding conflicts of interest related to Hewitt EnnisKnupp), whether advice provided by Hewitt EnnisKnupp is

In our opinion, it is indisputable that elimination of the sole fiduciary structure should have been the premier priority once the Treasurer Cowell took office given the long history of abuses involving the Treasurer's office. However, replacing it (as at least one of Cowell's advisors has recommended), with an investment committee comprised of experienced investment professionals operating in secrecy — an arrangement riddled with potential conflicts of interest, utterly lacking transparency and accountability — is outrageous and blatantly disingenuous.

Public pension reform and secrecy are, in our opinion, fundamentally incompatible.

Further, we believe the initial matters any such committee should immediately focus upon are the secrecy surrounding alternative investments and placement agents; hundreds of millions in undisclosed fees; the serious potential violations of law detailed in this report and, finally, the Treasurer's motivations and actions related thereto.

TSERS' Escalating High-Risk Alternative Investment Gamble

TSERS' escalating historic high-risk alternative investment gamble began over a decade ago in 2001. Allegations of impropriety relate back to inception of the failed strategy. Despite recurring controversies and allegations of corruption surrounding the former and current state treasurers over the years, as well as intermittent reports of dismal performance, the state pension has continued to dramatically increase its allocation to alternatives from 0.1 percent to 35 percent today,

---

truly independent, i.e., free of conflicts, is, at best, unclear. Whether conflicts of interest related to the firm are adequately disclosed in its SEC filings is a matter which should be reviewed further by the SEC, in our opinion.

adding tens of billions to these costly schemes that have been disastrous for TSERS.

Most often, the past and current Treasurer's justification for increasing alternatives has been the greater returns alternative investments offer—returns that repeatedly have failed to materialize.

Treasurer's "Experiment" Fails: A Decade of Soaring Fees to Wall Street Has Not Improved Performance

Early on in her tenure, the Treasurer defended shifting more and more pension assets to costly alternative managers, arguing that the hundreds of millions in additional fees to Wall Street would result in improved investment performance.

"We'll be looking for if we're paying higher fees for investments they better be performing and giving us a higher rate of return. Otherwise, it's a failed experiment," Cowell said.[8]

The Treasurer's candid admission that the TSERS historic high-risk gamble on alternative investments amounting to 35 percent of $87 billion, or over $30 billion, is an "experiment" is startling. The Treasurer should not be experimenting with tens of billions in state workers retirement savings; rather, as the sole fiduciary, she should be focused upon investing pension assets prudently.

However, even as of this date in 2010, the costly alternative investment experiment had already spectacularly failed — it had been severely underperforming for approximately eight years.

[8] Outside managers mean higher fees for N.C.'s pension fund, WRAL.com, April 26, 2010.

The Treasurer stated in 2010 that the "experiment is on a seven-to-ten-year cycle, and performance and fees will be weighed over that time frame."[9]

Twelve years after inception in 2002, the alternative investment experiment continues to cost the pension dearly and benefits only Wall Street.

Most important, there is no proof that alternative investments beat the market, as the Treasurer has repeatedly represented to the public. Indeed, possibly the world's greatest investor, the Oracle of Omaha, Warren Buffet, six years ago wagered $1 million that hedge funds would not beat the S&P 500 over the next ten years. At this point Buffet is still handily winning. The North Carolina state pension is not.

Billions in Underperformance to Date - Worst Yet to Come

In stark contrast to recent statements by the Treasurer that the additional investment flexibility granted by the legislature to permit TSERS to increase alternative investments will improve performance, the investment performance history clearly reveals that TSERS' alternative investments and the pension as a whole have performed poorly.

Over the past five years, under the Treasurer's watch, TSERS has underperformed the average public plan by **$6.8 billion**.[10]

Based upon the TSERS investment track record, it is highly likely, in our opinion, that increasing the allocation to high-cost, high-risk alternative investments that have consistently underperformed will result in billions greater performance losses, as well as approximately $90 million in

[9] Id.

[10] IMD Performance Review, Investment Advisory Committee Meeting, February 19, 2014.

additional disclosed fees paid to Wall Street money managers according to the Treasurer's estimates.[11]

While Wall Street is certain to emerge as a winner under the Treasurer's politically-driven alternative investment gamble, the stakeholders will, in our opinion, lose ever greater amounts due to rapidly escalating fees and plummeting net investment performance.

The Myth That Alternative Investments Provide Diversification and Reduce Risk

The Treasurer's argument that high-cost, high-risk alternative funds reduce risk or provide diversification is deeply flawed. Since many of the alternative investment managers may invest a substantial portion of a fund's capital in a single investment and substantially, or even completely, change their investment strategies at any time, there is no way TSERS can ensure that the alternative funds provide any meaningful portfolio diversification.

Further, while the massive additional cost and underperformance of the alternatives at TSERS are apparent at this time, the amount of any potential downside protection afforded is unproven and unknown.

Thus, it is impossible for the Treasurer, consistent with her fiduciary duty, to determine that the known cost related to any supposed risk reduction is reasonable.

[11] Id.

Massive Risk, Fiduciary Breaches and Violations of Law Revealed in Alternative Investment Documents

In order to assess the risks, potential fiduciary breaches and violations of law related to the hundreds of alternatives owned by TSERS, we reviewed the private placement offering memoranda related to certain of these investments.

A few of the offering documents we reviewed were provided by the Treasurer in response to our public records request. Other information the Treasurer refused to provide we obtained from independent sources, including the SEC.

The documents we reviewed indicate the alternatives are high-risk, speculative investments; the funds' investments are highly illiquid subject to enormous valuation uncertainty; the offerings involve serious conflicts of interest regarding valuation of portfolios by the managers themselves and calculations of fees, as well as opportunities for self-dealing between the funds, the managing partners and their affiliates that may, in our opinion, violate state and federal law.

For example, a manager may make investments for his own account in the very same assets in which the fund he manages invests, on more favorable terms and at the expense of investors in the fund, including TSERS. Alternatively, in the event that an investment opportunity is available in limited amounts, the manager may simply seize the entire investment opportunity for himself — robbing investors in the fund he manages, in breach of applicable fiduciary duties.

Accordingly, we recommend further investigation by the SEC of such potential fiduciary breaches and violations of law.

Hedge and other alternative fund offering documents often reveal that investors, such as TSERS, are required to consent to managers withholding complete and timely disclosure of material information regarding the assets in their funds. Further, investors must agree to permit the investment managers to retain absolute discretion to provide certain mystery investors, i.e., industry insiders, with greater information and the managers are not required to disclose such arrangements to TSERS.

As a result, TSERS is at risk that other unknown investors in funds are profiting at its expense—stealing from the pension.[12]

The identity of any mystery investors that may be permitted by managers to profit at TSERS' expense, as well as any relationships between these investors, the Treasurer or other public officials, should be investigated fully by law enforcement and the SEC. Such arrangements amount to a license to steal from the state pension.

The alternative fund offering documents also generally provide that the funds will invest in portfolio companies that will not be identified to the investors prior to their investment in the fund. As a result, TSERS will not have any opportunity to evaluate for itself information regarding the investments in which the funds will invest. Since pension fiduciaries are required to know, as well as evaluate the assets in which they invest, in our opinion, such provisions render these investments unsuitable for fiduciary accounts.

TSERS alternative funds generally disclose a litany of risky investment strategies they may pursue such as short-selling; investing in restricted or illiquid securities in which valuation uncertainties may exist;

[12] REVEALED: Gov. Christie's investment chief has major financial ties to firm that got $300M in NJ pension cash, Pandodaily, April 16, 2014.

unlimited leverage, as well as margin borrowing; options; derivatives; distressed and defaulted securities and structured finance securities.

Further, TSERS alternative investment documents reveal that managers may engage in potentially illegal investment practices, such as investing in loans that may violate the anti-predatory lending laws of “some states” and life settlement policies which give rise to lawsuits alleging fraud, misrepresentation and misconduct in connection with the origination of the loan or policy. In our opinion, an investigation should be undertaken by the SEC into the investment strategies of the alternative funds, as well as any underlying funds, to determine whether any violations of law exist.

Unlike traditional investments, the alternative funds in which TSERS may invest may be managed by investment advisers not registered with the SEC under the Investment Advisers Act of 1940. Further, the funds themselves are not registered as “investment companies” under the Investment Company Act of 1940. As a result, the limited partners lack many meaningful protections of those statutes.

There is no evidence the Treasurer, or the State Auditor, is aware of, or has ever considered, the unique risks related to the lack of these statutory protections.

Alternative investment funds that are incorporated and regulated under the laws of foreign countries, present additional, unique risks which pension fiduciaries must consider. Further, since TSERS’ alternative investment assets are held at different custodians located around the world, as opposed to being held by TSERS’ master custodian, the custodial risks are heightened and should be considered and disclosed to the public.

There is no evidence the Treasurer, or the State Auditor, is aware of, or has ever considered, the unique risks related to foreign regulation and custody of alternative funds. Further, based upon our conversations with the State Auditor, only the Treasurer knows whether the alternative investment funds are, in fact, audited annually — as represented in the state CAFR.

Our forensic investigation into specific potential violations of law we identified involving the hundreds of private equity investment funds in which TSERS invests was severely hampered by the Treasurer's repeated refusal to provide the documents we requested.

In light of a recent internal review by the SEC indicating that more than half of approximately 400 private-equity firms the SEC staff examined charged *unjustified fees and expenses* without notifying investors,[13] we requested documents related to such potential violations of the securities laws from the Treasurer. Our request was denied.

Accordingly, in our opinion, whether any of the hundreds of TSERS private equity funds have been charging "bogus" fees to portfolio companies in violation of the federal securities laws is a matter that should be referred to the SEC for further investigation, as well as potential refund to TSERS of its share of any fees improperly charged.

In light of recent SEC whistleblower allegations that private equity firms have been violating securities laws by charging *transaction fees without first registering as broker-dealers* with the SEC,[14] we requested information regarding such potential violations of the securities laws from the Treasurer. Our request was denied.

---

[13] Bogus Private-Equity Fees Said Found at 200 Firms by SEC, Bloomberg News, April 7, 2014.

[14] A whistleblower wants to take away private equity's 'crack cocaine,' CNBC, December 5, 2013.

Accordingly, in our opinion, whether any of the hundreds of TSERS private equity funds have been charging transactions fees in violation of the securities laws is a matter that should be referred to the North Carolina Secretary of State Securities Division and the SEC for further investigation, as well as potential refund to TSERS of its share of any transaction fees illegally charged.

In light of whistleblower claims that have been filed with the IRS alleging that hundreds of private equity so-called *monitoring fees paid by private equity owned portfolio companies* are being improperly characterized as tax-deductible business expenses (as opposed to dividends, which are not deductible), costing the federal government hundreds of millions of dollars annually in missed tax revenue,[15] we requested information regarding such potential violations of federal tax law from the Treasurer. Our request was denied.

Based upon our preliminary research it appears that at least three monitoring agreements involving *a single* TSERS private equity fund may be suspect to re-characterization by the IRS.

Given the hundreds of other TSERS private equity fund investments and hundreds of suspect monitoring fees identified by credible whistleblowers, it seems virtually certain that additional violations of tax law exist with respect to TSERS private equity investments.

Accordingly, in our opinion, whether any of the hundreds of portfolio companies owned by TSERS private equity funds have been improperly characterizing monitoring fees as business expenses in violation of the Internal Revenue Code and costing the federal government hundreds of

[15] Tax Expert Sees Abuse in a Stream of Private Equity Fees, New York Times Deal Book, February 3, 2014. Private-Equity Firms' Fees Get a Closer Look, Wall Street Journal, February 2, 2014.

millions annually in tax revenue is a matter that should be referred to the IRS and SEC for further investigation.

Since the IRS in recent years has been examining the propriety of private equity *management fees waivers,* which have allowed many fund executives to reduce their taxes by converting ordinary fee income into capital gains taxed at substantially lower rates, costing the federal government billions of dollars annually in missed tax revenue,[16] we requested information regarding potential violations of tax law related to these waivers from the Treasurer. Our request was denied.

Accordingly, in our opinion, whether any of the TSERS private equity funds have been complicit in allowing their managers to improperly convert ordinary fee income into capital gains is yet another matter that should be referred to the SEC and IRS for further investigation.

Treasurer Conceals Investment Fees Will Skyrocket to $1 Billion

While the Treasurer has a fiduciary duty to ensure that fees TSERS pays money managers for investment advisory services are reasonable, as well as a statutory duty to disclose all direct and indirect investment and placement agent fees, she has failed to monitor and disclose all fees paid by TSERS.

The Treasurer has withheld from public disclosure a massive portion of the fees and expenses related to alternative assets, resulting in the dramatic understatement of fees, expenses and risks related to these investments, as well as TSERS as a whole.

In a letter dated February 27, 2014, we notified Cowell that based upon our preliminary review of the limited information provided in response to SEANC's public records request, it was apparent that the Treasurer

[16] IRS Wakes Up to Private Equity Scam, Naked Capitalism, October 16, 2013.

had failed to disclose a significant portion of the hedge fund and alternative investment manager fees paid by TSERS to money managers. Indeed, it appeared that the massive hidden fees she failed to disclose in many instances dwarfed the excessive fees disclosed to us.

The limited investment fee information provided by the Treasurer indicates that disclosed fees have skyrocketed over 1,000 percent since 2000 and have almost doubled since FY 2008/2009 from $217 million to $416 million. In the past fiscal year alone, disclosed fees have climbed from $295 million to $416 million — a staggering increase of more than over 40 percent.

Worse still, according to Cowell, annual investment fees are projected to increase about 10 basis points—another almost $90 million—due to the allocation away from low-cost internally managed fixed income to high-cost, high-risk alternative funds managed by Wall Street.

In summary, the total investment fees as disclosed by the Treasurer are projected to climb to over **$500 million**.

Unlike traditional investments, such as stocks, bonds and mutual funds, alternative investments are opaque and subject to myriad hefty fees.

Based upon our limited review of TSERS' investments, we estimate total undisclosed fees will comparably climb to approximately **$500 million**.

Thus, we estimate total TSERS annual fees and expenses will amount to approximately **$1 billion** in the near future — almost twice the figure projected and disclosed by the Treasurer.

The increase of disclosed fees in 2013 to $416 million, while alarming, is a gross and intentional understatement by the Treasurer, in support of her failed alternative investment strategy. In our opinion, if the

magnitude of the formidable undisclosed fees related to TSERS alternative investments were acknowledged, public acceptance of the Treasurer's high-risk, underperforming investment gamble would wane.

Past and Present Placement Agent Abuses at TSERS

While Treasurer Cowell publicly acknowledged the importance of adopting a pay-for-play and placement agent policy in 2009, disclosure has not meaningfully improved during her tenure. Further, her investigation of placement agent abuses has languished for the past five years. Placement agent controversies remain profoundly unresolved.

Rather than promote transparency and accountability regarding placement agent usage at TSERS, the record reveals that the Treasurer has intentionally withheld, as well as sought to thwart the release of, damning placement agent information since taking public office.

Cowell did not disclose to the public in May 2009, or at any time subsequent, that she had received a SEC Letter of Inquiry regarding placement agents at TSERS. Worse still, she requested that neither the cover letter nor any other documents provided by her in connection with the SEC Inquiry be released by the SEC to the public in response to a request under the federal Freedom of Information Act. Cowell even asked to be given at least ten days prior notice and an opportunity to object to the Commission to the granting of any Freedom of Information Act request and, if necessary, to seek an appropriate protective order in the courts.

Despite repeated requests from the SEC, the Treasurer failed to disclose even a *single* placement agent payment amount in 2009.

In April 2010, the consulting firm of EnnisKnupp retained by Cowell recommended that to promote transparency and accountability, details

regarding placement agent compensation be posted on the Treasurer's website for disclosure to the public.

While the Treasurer's Office implemented certain of EnnisKnupp's recommendations, it did not and still has not implemented this key recommendation regarding public disclosure of placement agent compensation called for by best practices, according to Ennis.

Worse still, the Placement Agent Policy adopted by the Treasurer in 2009 expressly permits an investment manager or placement agent to designate as a trade secret under North Carolina law the placement agent identity, services and compensation. Cowell has refused to disclose millions in TSERS placement agent payments, claiming trade secrets.

In 2013, the law firm of Kellogg, Huber, Hansen, Todd, Evans & Figel, P.L.L.C., hired by the Treasurer to review certain placement agent matters, in its Final Report called upon Cowell to disclose placement agent compensation amounts on the Treasurer's website — as originally recommended in 2010 by EnnisKnupp and ignored by her for more than three years.[17]

To date, the placement agent fee amounts paid by each TSERS manager and the total amount of placement agent compensation have not been disclosed to the public on the Treasurer's website, or anywhere else.

The incomplete information provided to the public regarding placement agents on her website is so disorganized and unreliable that it can only confuse and mislead the public, in our opinion. Further, as a result of Cowell's willingness to permit managers to designate certain placement agent fees as secret, the fees disclosed are obviously understated.

[17] Special Review for the North Carolina Department of State Treasurer, Final Report, December 11, 2013, page 19.

Assuming that the Treasurer has enforced compliance with the placement agent policy (which requires disclosure of the fees paid to her), the relevant information is readily-available — indeed already known to her.

According to statements attributed to the Treasurer,[18] a staggering 50 percent of TSERS managers pay placement agent fees that range from 1 percent to 2 percent.

Our investigation reveals that TSERS placement agent percentages *alone*, in fact, range as high as **3 percent**. In addition to the percentage fees, there are monthly retainers, expenses and discretionary bonuses included in the agent's total compensation. We have not factored these amounts, which may be significant, in our estimate below.

It appears that for the past five years Cowell has intentionally withheld from public scrutiny arguably the most significant information regarding placement agent fees — the fact that TSERS has secretly squandered a staggering estimated **$180 million** in avoidable fees to dispensable intermediaries for conflicted, unreliable investment advice.

Due to the highly significant amounts secretly paid for questionable so-called investment services and the Treasurer's apparent unwillingness to disclose such placement agent compensation amounts to stakeholders — even as required under state law — we recommend that further investigation by the SEC is needed at this time.

Dubious North Carolina Nexus Investments and Influence-Peddling

[18] NC pension fund to strengthen transparency measures for 'placement agents,' newsobserver.com, December 16, 2013.

A significant portion of TSERS's alternative investments, including but not limited to the North Carolina Innovation Fund and the other Credit Suisse/North Carolina funds, are invested in private equity funds and companies that are based in North Carolina. Both the current and prior Treasurer have/had policies giving preference to local funds and enterprises.

Pension policies targeting local businesses give rise to heightened concerns regarding potential improper relationships between locals and pension decision-makers that may result in imprudent investments.

In our opinion, many of the local private equity funds and companies in which TSERS has invested clearly lacked the requisite relevant experience and track records generally required by pensions. Not only did TSERS "seed" many of these funds and businesses apparently lacking merit, it continued to leave substantial assets at risk in them long after, in our opinion, it became apparent that their services were uncompetitive.

In our opinion, an investigation by law enforcement and the SEC into the facts and circumstances regarding many of the North Carolina nexus investments should be undertaken and would reveal imprudent decision-making based upon improper relationships, as well as outrageous profiteering.

Treasurer's Heavy Reliance upon Troubled Credit Suisse

Clearly, Credit Suisse, a firm which has a significant presence in North Carolina in the form of 1,000 employees based in the Research Triangle Park has had a substantial, complex, secretive and highly lucrative relationship with both the current and past Treasurer. Due to the variety of investment services provided, the relationship is fraught with myriad potential conflicts of interest. Further, the firm's management of

investment funds that target North Carolina enterprises is a pivotal, potentially politically sensitive assignment.

In our opinion, in light of the TSERS's longstanding heavy reliance upon Credit Suisse — a firm involved in numerous grave regulatory controversies globally at this time;[19] the variety of services the firm provides and the myriad potential related conflicts of interest — further investigation of the relationship between the Treasurer, TSERS and the firm by the SEC is merited at this time.

We note that with respect to the majority of alternative investments made by TSERS where the investment managers involved have been permitted to designate the compensation arrangements involving millions of dollars they have entered into with placement agents as "trade secrets" under North Carolina law, Credit Suisse Securities is the named placement agent receiving the secret compensation.

END EXECUTIVE SUMMARY

[19] Among other matters, on February 14, 2014, the SEC announced charges against Zurich-based Credit Suisse Group AG for violating the federal securities laws by providing cross-border brokerage and investment advisory services to U.S. clients without first registering with the SEC. Credit Suisse agreed to pay $196 million and admit wrongdoing to settle the SEC's charges. The SEC is also currently investigating whether Credit Suisse Group AG improperly shifted money in its private banking unit to obscure a drop in asset growth amid a U.S. probe of tax evasion at Swiss Banks.

North Carolina Pension's Secretive Alternative Investment Gamble: A Sole Fiduciary's Failed "Experiment"

I. Introduction

On December 31, 2013, Benchmark Financial Services, Inc. ("Benchmark") was retained by the State Employees Association of North Carolina, SEIU Local 2008, to provide a preliminary expert forensic review of the Teachers' and State Employees' Retirement System of the State of North Carolina ("TSERS").

The State Employees Association of North Carolina ("SEANC") is the South's leading public employees association comprised of 55,000 state employees and retirees who have chosen to empower themselves and the public services they provide by joining together to increase their collective strength in the halls of the North Carolina General Assembly, Retirement Systems Board of Trustees and State Health Plan.

As a member-driven organization, SEANC members provide direction for the association and set the annual legislative agenda.

In 2013, SEANC convention delegates voted, once again, to seek legislation from the General Assembly to remove the sole fiduciary authority (discussed further below) currently vested in the North Carolina State Treasurer with respect to TSERS.

Remarkably, TSERS, which has a single elected official, the Treasurer, select and monitor all investments made by the pension on behalf of state employees and retirees, is more than four times greater than the state's annual budget, which has 170 General Assembly members voting on funding matters.

SEANC members have a vested interest in the state retirement system as the primary and most consistent contributors to it. Each month state employees contribute 6 percent of their paychecks into the retirement system.

After years of scandalous investment practices, first exposed in a Forbes magazine article regarding TSERS titled, "Pensions, Pols and Payola,"[20] in 2007 SEANC increased its scrutiny of TSERS' investment fees, lack of transparency and mounting investments in risky hedge, private equity, venture and real estate alternative investments.

Most recently, in 2013, SEANC fought vigorously against an expansion of the Treasurer's authority to invest TSERS assets in alternatives due to the high fees and risks, as well as dismal rates of return associated with these investment schemes.

While the Treasurer requested authority from the legislature to invest up to 40 percent in risky, secretive alternative investments, due to SEANC opposition, the final legislation increased investment authority by only 1 percent beyond the existing portfolio allowance to 35 percent.

In essence, SEANC serves as the watchdog in the TSERS system, which lacks a prudent governance structure of checks and balances.

Toward that end, SEANC felt compelled to enlist an independent, nationally known expert in retirement system forensics to conduct a comprehensive review of TSERS.

Today the assets of TSERS are directly invested in approximately 300 funds and indirectly in hundreds more underlying funds (through funds of funds), the names, investment practices, portfolio holdings, investment performances, fees, expenses, regulation, trading and custodian banking arrangements of which are largely unknown to

[20] Forbes, February 23, 2007.

stakeholders, the State Auditor and, indeed, to even the Treasurer and her staff.

As a result of the lack of transparency and accountability at TSERS, it is virtually impossible for stakeholders to know the answers to questions as fundamental as who is managing the money, what is it invested in and where is it?

The Treasurer is the sole fiduciary of TSERS funds and, as such, is legally obligated to make prudent investment decisions based solely upon the best interests of the plan. On the other hand, as an elected official, Treasurer Cowell relies upon contributions from Wall Street money managers and other providers of services to the pension, including plaintiff class action and other law firms, to finance her campaign efforts.

The Treasurer also has relationships with other state officials in need of contributions which the prospect of lucrative contracts to manage billions in state pension assets may attract.

Further, the growing, already significant billions in pension assets committed to investments in enterprises with a nexus to North Carolina presents a heightened risk of improper dealings and yet another discrete opportunity to use pension assets for political advantage.

In our opinion, billions in TSERS investments can only be explained by the improper collateral benefits they provide to the Treasurer—as opposed to any supposed investment merit.

It is indisputable that TSERS' disclosed investment management costs alone (i.e., not including the enormous hidden costs revealed in this report) have skyrocketed in recent years and are projected by the Treasurer to steeply climb. Investment risk has grown to a record crisis

level. Performance of hedge funds, private equity and real estate alternative investments has been beyond bad — horrific — for over a decade.[21] Pay-for-play and transparency reforms promised by the Treasurer have failed, year after year, to materialize — despite multiple costly expert reviews paid for by the pension.

In this preliminary investigation Benchmark identified widespread potential violations of law within the TSERS investment portfolio including, but not limited to the following: fraudulent representations related to the performance of alternative investments; concealment and intentional understatement of $400 million in annual alternative investment fees and expenses to date; concealment of approximately $180 million in placement agent compensation; the charging of bogus private equity fees; violations of securities broker-dealer registration requirements related to private equity transaction fees; securities and tax law violations regarding investment management fee waivers and monitoring fees; self-dealing involving alternative investment managers; mystery investor liquidity and information preferences amounting to licenses to steal from TSERS; and pension investment consultant conflicts of interest; predatory lending and life settlement related fraud.

We note with great emphasis that this investigation was conducted without the power to compel the Treasurer to comply with state disclosure laws or provide the documents we requested—critical investment information which she has to date refused to provide to any stakeholders (including the legislature)—and represents our expert

---

[21] According to pension consultant Cliffwater LLC, for the ten years ending June 30, 2011, for 23 reporting pensions, TSERS ranked 21—underperforming the State Fund Real Estate Average of 6.7 percent by a massive 4 percent. For the ten years ending June 30, 2011, for 23 reporting pensions, TSERS ranked 23—hugely below the Private Equity Average of 9.3 percent by more than 7 percent. As of June 30, 2013, hedge, private equity and real estate 10-year performance remains glaringly below even the more-forgiving custom benchmarks the Treasurer uses to measure performance.

opinions based upon limited material provided by the Treasurer, as substantially supplemented by relevant information obtained from other reliable pension investment management industry sources, including regulators and the pension investment managers themselves.

Finally, in light of the serious potential harm to TSERS, we strongly recommend further investigation of, as well as referrals to authorities where appropriate, of the fiduciary breaches and potential violations of state and federal tax, securities and other laws identified herein.

II. Treasurer's Lack of Transparency

Forensic investigations of pensions require access to evidence. Contrary to initial public statements by the Treasurer indicating a willingness to cooperate with our investigation,[22] she has made conducting this review on behalf of TSERS stakeholders far more difficult by withholding the overwhelming majority of the information we requested.

Throughout her tenure, the Treasurer has repeatedly stated publicly that she is committed to transparency. In contrast, she has proved unwilling to disclose to the public even the minimum pension information required under state law. Further, her office has, in our opinion, released information regarding TSERS to the public that has often been left intentionally incomplete and made deliberately misleading.

[22] SEANC hires forensic investigator to look at pension fund, January 6, 2014, newsobserver.com.

It is also notable that the Treasurer has failed to disclose certain significant investment manager fee and performance data that her oft-criticized predecessor, Richard Moore, had voluntarily provided.

All of the financial information we requested in connection with this investigation was readily available to Cowell and of obvious materiality to TSERS participants, taxpayers and investors.

Perhaps most disturbing, in response to our specific requests the Treasurer refused to disclose offering memorandum and other key documents (including information regarding millions in placement agent fees) related to TSERS costly, high-risk alternative investments, citing supposed "trade secret" concerns raised by the alternative managers.

The Treasurer's claim that the state is contractually obligated to defer to the alternative managers on the release of so-called proprietary information without challenge is, in our opinion, indefensible. Delegating to private entities the decision as to what records are available under the state open-records law would, obviously, effectively nullify it.

Further, any agreements signed by the Treasurer to keep secret information regarding pension fees would appear to violate the state law which mandates full disclosure of all direct and indirect investment management and placement agent fees.[23]

While the Treasurer claims that alternative manager opposition to release of material information about their operations to any party precludes disclosure, in our professional experience that's unlikely. If the Treasurer truly wanted such information made public, the investment

[23] NCGS 147-69.2(b)(10a)

managers, faced with the prospect of losing TSERS assets under their management, would comply.

Benchmark routinely reviews such alternative investment documents on behalf of pensions and participants in plans and, as indicated below, was able to expeditiously obtain the supposedly secret documents related to certain TSERS alternative investment funds.

On the other hand, if the managers are truly unwilling to submit to public scrutiny, in our opinion, they should not be entrusted with public pension assets.

Ironically, a review by the Wall Street Journal of more than 100,000 federal Freedom of Information Act requests recently revealed that hedge fund managers have been using open-government laws to troll for financially-relevant information to fuel their profits. "It's an information arms race," one manager is quoted as saying. "It's important to try every avenue. If anyone else is doing it, you need to do it too."[24]

To permit Wall Street alternative investment managers to mislead the public and profit from thwarting open-government and other laws is contrary to sound public policy.

Viewed from a regulatory and public policy perspective, the Treasurer's practice of withholding relevant information and intentionally providing incomplete or inaccurate disclosures regarding TSERS investments results in: (1) concealing potential violations of state and federal laws, such as those detailed throughout this report; (2) misleading the public as to fundamental investment matters, such as the true costs, risks, practices and investment performance related to hedge, private equity,

[24] Open-Government Laws Fuel Hedge Fund Profits, Wall Street Journal, September 23, 2013.

venture and real estate alternative investment funds; (3) understating the costs and risks related to TSERS investments specifically; (4) misrepresenting the investment performance and financial condition of the state pension to investors in state obligations.

As stated on the website of the United States Securities and Exchange Commission ("SEC"):

"The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions."

On the other hand, when state officials and pension funds, such as the Treasurer and TSERS, intentionally withhold or misrepresent basic facts regarding investments material to evaluating investments, the pool of knowledge all investors can rely upon becomes contaminated.

In our opinion, there is simply no reason participants in TSERS, who rely upon the investment decisions made by the Treasurer for their retirement security, and other stakeholders, should be provided with unreliable investment information—afforded less protection under the state and federal securities laws—than investors in shares of public companies and mutual funds.

III. Nation's Seventh Largest Public Pension Has No Audited Financials

Remarkably, there are no audited financial statements for TSERS, the seventh largest public pension in the nation with in excess of $87 billion

in assets. We are unaware of any other public pension that completely lacks financial statements audited by either an independent accounting firm or the State Auditor, or both.

This represents a major material weakness in the State of North Carolina Comprehensive Annual Financial Report (“CAFR”) which is relied upon by ratings agencies, municipal bond holders and the federal government in providing assistance to states.

Certain limited pension information provided by the Department of the State Treasurer for the CAFR prepared by the Statewide Accounting Division, Office of the State Controller and included within the approximately 300-page CAFR, is supposedly audited by the State Auditor’s office. However, no audit of TSERS investments has ever been performed and there are no publicly available separate financial statements for the pension.[25]

Further, we note that the State Auditor did not audit for the CAFR the financial statements of the State Lottery; Turnpike Authority; Housing Finance Agency; State Education Assistance Authority; University of North Carolina System; Supplemental Retirement Income Plan; or the cash basis claims and benefits of the Health Plan—all of which were audited by other auditors whose reports were furnished to the State Auditor.

Contrary to the dictates of common sense, the largest state fund, upon which hundreds of thousands of state workers and retirees depend for their retirement security, fails to be audited.

---

[25] Indeed, many larger public pensions, such as New York State Common Retirement Fund, in order “to provide the public with a clear view of their management and investments,” provide a CAFR for the pension alone that details pension assets and a monthly report that gives fund investments and transactions. Included in the New York Common Retirement Fund CAFR is the independent auditor (KPMG LLP) report.

State Auditor Beth Wood indicated in a recent interview prompted by our concerns: "Our office audits the teacher and state employee pension fund every year as part of the state's Comprehensive Annual Financial Report. While this audit is not issued in a separate report, the pension fund numbers in the CAFR are fairly stated."[26]

The State Auditor declined to answer a list of probing questions we had prepared for her, including several questions related to the scope and depth of her audit of TSERS and whether the resources committed to auditing the pension had grown to keep pace with the increasing complexity of the pension.[27]

A primary goal of ours was to determine whether the State Auditor's procedures have evolved to reflect the fact that the TSERS asset allocation has changed dramatically in recent years from 5 percent alternative investments, to now 20 percent and as much as 35 percent in the future, invested directly in more than 300 external funds and indirectly in hundreds more through funds of funds, with portfolios consisting of substantial illiquid, hard-to-value assets custodied all over the world.

---

[26] N.C. pension investigator 'disturbed' by fund's audit practices, Triangle Business News, January 23, 2014.

[27] Included in the list submitted to the State Auditor were important questions such as: What is the size of the audit team sent to audit the Treasurer's office and what is their length of stay during the audit? Have the resources committed to auditing the Treasurer's office grown to keep pace with the increasing complexity of the pension? With respect to assets of the pensions that are not custodied with the fund's master custodian, what steps have been taken to verify the existence and value of these assets? With respect to assets which are hard-to-value (not publicly traded) or illiquid for any reason (e.g., subject to partnership lock-ups) how are these assets valued? What amount and percentage of the pensions' assets are subject to leverage? With respect to placement agent fees paid by the fund's managers, are these amounts disclosed anywhere in the financials? Has the State Auditor identified any conflicts of interest related to the investment vendors to the pensions which should be disclosed?

Based upon statements by the State Auditor and her staff to us and in the media, in our opinion, the Office of the State Auditor is not even aware of the myriad new fees, expenses and risks facing TSERS and has not begun to focus upon the emerging critical issues related to alternatives we identified.[28]

We note that other state auditors across the nation are increasingly expressing concerns regarding the integrity of public pension financial statements and alternative investment fees and expenses.[29]

Further, in our opinion, there is nothing in the CAFR to suggest that the State Auditor has modified audit procedures with respect to TSERS in response to the greater risks related to alternative investments.

In response to our concerns regarding the failure to audit TSERS, Treasurer Cowell's office issued its own statement recently, stating the pension information it submitted for the CAFR is, "comprehensive and meets all of the required disclosures that would be required for a stand-alone audit for each plan." The statement adds that "the high costs of a

---

[28] "Mr. Siedle also asked me whether we had performed audit procedures that would be outside the scope of a financial statement audit," Wood wrote in an email. "Not answering questions about an agency for which I have no administrative responsibility or not discussing audit procedures *outside the scope of the audit we perform* (emphasis added) does not indicate that I have no interest in Mr. Siedle's work. I am deeply interested both as a taxpayer and a member of the Council of State. N.C. pension investigator 'disturbed' by fund's audit practices, Triangle Business News, January 23, 2014. In summary, the State Auditor admitted in this email that the audit of TSERS she performs does not include the matters we raised.

[29] For example, in 2013, the Office of the Auditor General of Rhode Island issued a report regarding the state pension indicating that the pension's 2012 "financial statements did not include investment expenses associated with hedge funds, and some private equity and real estate investments." Independent Auditor's Report On Internal Control Over Financial Reporting and On Compliance And Other Matters Based Upon An Audit of Financial Statements Performed in Accordance With Government Auditing Standards, Schedule of Findings and Responses Fiscal Year Ended June 30, 2012. In Utah, the state auditor has raised concerns regarding the reporting of performance of the state pension. Auditor raises flags about Utah retirement system, Salt Lake tribune, February 27, 2013.

stand-alone audit would be unlikely to produce any significant additional information."[30]

While the State Auditor and State Treasurer seemingly agree at this point in time regarding the integrity of the pension information submitted by the Treasurer to the State Auditor, in recent years they have not.

For example, the State Auditor concluded in a report released in 2011 that the State Treasurer's office failed to report $771 million in losses on the fair value of cash collateral received from securities lending activities related to TSERS. The Treasurer's office also failed to report $108 million in gains on investments made with securities lending collateral.

"The net impact of not reporting the investment transactions in the 2009 fiscal year resulted in the Investment Pool's June 2009 net assets being overstated by approximately $663 million," the auditor's report stated.[31]

The transactions were ultimately reflected in the Treasurer's June 2010 financial statements, in the fiscal year after they occurred. According to a 2011 article in Forbes, "When questioned about the failure to disclose the securities lending loss, the Treasurer's office was less than forthcoming, in the view of state auditors."

"There was a significant deficiency in our estimation in the response that the Treasurer sent to us," said Dennis Patterson, a spokesman for

[30] N.C. pension investigator 'disturbed' by fund's audit practices, Triangle Business News, January 23, 2014.

[31] Department of State Treasurer, Statewide Financial Statement Audit Procedures for the Year Ended June 30, 2010.

the State Auditor. "We felt they [the Treasurer's staff] were attempting to downplay the seriousness."[32]

Said Forbes writer Neil Weinberg, "The North Carolina treasurer's failure to report its jumbo-sized loss raises fresh questions about the ability of state and local governments to safeguard the vast sums of public money entrusted to them."[33]

According to published reports, finally three years later, in March 2012, the State Treasurer filed a lawsuit against Bank of New York Mellon, claiming it made an unauthorized $95 million investment in Lehman Brothers Notes in December 2006.[34] Nevertheless, as mentioned below, Bank of New York Mellon apparently continues to serve as the master trustee for TSERS traditional equity-based assets.

Also, in 2012, a state audit found the state's CAFR was incomplete and could have been misleading because it did not report that the state owned about $5.5 billion of investments in Fannie Mae, the troubled mortgage lender. The investments represented 6 percent of the total investment pool. State law requires any asset that comprises 5 percent be disclosed. The audit determined the State Treasurer's Office did not have sufficient procedures in place to ensure that all required disclosures were included.[35]

At the outset it is important to acknowledge that *even if* the pension information submitted for the CAFR by the Treasurer meets all of the required disclosures for a stand-alone audit of TSERS and a meaningful

---

[32] N.C. Treasurer Buried $771 Million Securities Lending Loss, Forbes February 18, 2011.

[33] As noted in the Forbes article, the State Auditor also determined that the Treasurer had once again exceeded its statutory limits on investments in hedge fund and other alternative assets.

[34] North Carolina sues Bank of New York Mellon over Lehman investment, Pension & Investments, March 15, 2012.

[35] Treasury reprimanded over investment disclosure, The News & Observer, January 3, 2012.

portion of such information is actually audited by the State Auditor (both of which we question), that is not to say that the CAFR—the only financial statements regarding TSERS that are publicly available—effectively communicates the financial condition of TSERS comparable to a stand-alone audit of a pension, or that separate, audited financial statements for TSERS could not vastly improve the breadth and quality of the information provided to the public—especially with respect to complex or controversial investment practices, such as alternative investments, securities lending, valuation and custody.

In our opinion, the statement by the Treasurer that the "high costs" of a stand-alone audit would be "unlikely to produce any significant additional information" is dead wrong in two respects.

First, it is indisputable that separate, audited financial statements for TSERS *could* vastly improve transparency and accountability. Not only would separate financial statements be far easier for stakeholders to read and understand than the massive 300-page CAFR that lacks meaningful detail regarding pension investments specifically, disclosures in the statements and notes could easily be enhanced to include new information regarding the high-risk, high-cost complex investments TSERS is migrating toward in ever-greater percentages—assuming, of course, the Treasurer desires to effectively communicate such potentially alarming information to the public.

Second, the Treasurer either has limited knowledge of the cost of a pension audit or is intentionally misleading the public as to audit costs in her statement referred to above.

In fact, the cost of an audit of TSERS would likely amount to approximately $150,000—a mere fraction of even a single of the estimated over $180 million in avoidable placement agent fees, discussed below, the Treasurer has permitted TSERS managers to

secretly pay to dispensable intermediaries for, at best, unreliable conflicted advice in connection with the pensions' investments.

Further, in our opinion, a separate truly independent financial audit which should improve oversight and management of pension investments, reveal deficiencies (including fraud and other malfeasance), and produce savings exponentially greater than any limited audit cost, is decades overdue.

The notion that the cost of a separate audit is prohibitive, as the Treasurer has stated, is absurd.

In order to glean any information about TSERS, readers must comb through the 300-page CAFR for answers that often are not there and decipher or extrapolate the dollar amounts and footnotes that apply specifically to TSERS — assuming interested readers even know to look at the CAFR for information specifically related to the state pension. In our opinion, this is an overwhelming task for even seasoned investors — and needlessly so. Worse still, it's not worth the effort.

When we asked, "Where's the pension money," a State Auditor staffer initially seemed perplexed and then disputed such information was material.[36] As we pointed out, surprisingly, nowhere in the CAFR is the name of any trustee or master custodian holding TSERS assets disclosed. While it is stated that there is a trustee and that the trustee maintaining custody of the equity-based assets also engages in securities lending transactions with respect to these assets, the name of the trustee/lending agent is not disclosed.

Notes to pension financial statements regularly disclose the identity of the master custodian because it is material information investors need

[36] Telephone interview with Joyce Bonnie, Office of the State Auditor, February 10, 2014

and want to know. After all, if investors cannot even determine what institution is holding their money and where it is invested, as well as assess the integrity of that party, their investment is arguably fundamentally insecure.

According to the State Auditor, the trustee holding TSERS equity-based assets and lending its securities is Bank of New York Mellon. As mentioned earlier, the State Treasurer is one of a number of parties currently involved in litigation against the bank regarding $95 million in securities lending losses.[37]

More unsettling, beginning in December 2009, government authorities have been conducting inquiries seeking information relating to foreign exchange transactions in connection with custody services Bank of New York Mellon provides to public pension plans and certain other custody clients.[38]

In one securities fraud class action, plaintiffs, including the State of Oregon, allege that Bank of New York Mellon and certain of its officers and directors failed to disclose that the company illegally rigged the price of its foreign exchange currency services, a practice which a former

---

[37] BNY Mellon or its affiliates have been named as defendants in a number of lawsuits initiated by participants in BNY Mellon's securities lending program, which is a part of BNY Mellon's Investment Services business. The lawsuits were filed on various dates from 2009 to 2013, and are currently pending in courts in New York, North Carolina and Illinois and in commercial court in London. The complaints assert contractual, statutory, and common law claims, including claims for negligence and breach of fiduciary duty. The plaintiffs allege losses in connection with the investment of securities lending collateral, including losses related to investments in Sigma Finance Inc., Lehman Brothers Holdings, Inc. and certain asset-backed securities, and seek damages as to those losses. Bank of New York Mellon Corporation, Form 10-Q September 30, 2013.

[38] Id.

Bank of New York Mellon currency trader described as "**raping the client accounts**."[39]

Whether Bank of New York Mellon provides foreign exchange services to TSERS in connection with custody services is not disclosed in the CAFR.

In light of the "bundle" of conflicted services commonly provided by pension custodians; the unauthorized securities lending losses to TSERS currently in litigation; and the serious allegations regarding the bank's foreign currency exchange services, a review of the services provided, as well as services not provided, by the bank is recommended.

For example, nowhere in the CAFR is it disclosed that approximately 20 percent of TSERS assets, almost $18 billion, is invested in alternative assets held at different custodians located around the world regulated under the laws of foreign countries, as opposed to being held by Bank of New York Mellon and that, as a result, the custodial risks are heightened.

According to the State Auditor's Office, "only the Treasurer knows which assets are at Bank of New York and which are not."[40]

---

[39] In re Bank of New York Mellon Corp. Forex Transactions Litigation, United States District Court for the Southern District of New York, 12 MD 2335. According to plaintiffs, "While BNY Mellon offered its custodial clients foreign currency exchange services "free of charge" and at "best execution" spreads, it would actually book its clients' transactions at the most unfavorable daily rate, rather than at the prevailing rate at the time the transaction was consummated. This scheme allowed BNY Mellon to extract hundreds of millions of dollars in illicit gains and misleadingly inflate its reported financial results. Plaintiffs allege that BNYM concealed its fraudulent practices from investors thereby misrepresenting its foreign exchange revenue, the degree and quality of risk attached to its foreign exchange revenue, and the Company's exposure to legal liability when its illicit conduct was inevitably exposed."

[40] Telephone interview with Joyce Bonnie, Office of the State Auditor, February 10, 2014.

Further, the CAFR does not indicate that many of the alternative funds TSERS has invested in are incorporated and regulated under the laws of foreign countries and present additional, unique risks which pension fiduciaries must consider.

Recently, three Louisiana public pensions which invested $100 million in a troubled fund managed by Fletcher Asset Management, have struggled in Cayman Islands courts to have the fund liquidated and recoup their investment. A Louisiana state legislative auditor criticized the investment practices of the three funds. The report found, among other issues, that the public pensions did not adequately document whether they would be able to liquidate each investment in their portfolio at a fair market price and within a reasonable time frame.[41]

While the CAFR financial statements indicate the aggregate value of the assets held in the State Treasurer Investment Pool and the Notes indicate the individual investment portfolios maintained in the External Investment Pool, TSERS holdings in each investment portfolio are not disclosed and details regarding each investment portfolio holdings are scant. Indeed, there is absolutely no disclosure of the substantial risks and costs related to the alternative investments in the notes.[42]

The CAFR states that with respect to the Alternative Investment portfolio (private equity investment partnerships and hedge funds), the Real Estate Investment portfolio (limited partnerships and other investments), the Credit Investment and Inflation Protection Investment portfolios (limited partnerships, hedge funds, and other non-publicly

[41] Fletcher Fallout: Louisiana Auditor Criticizes Pension Funds, Wall Street Journal, June 5, 2012.

[42] According to the CAFR, the pension trust funds are minor participants in the Short-term investment portfolio; primary participants in the Long-term Investment portfolio and the sole participants in the External Fixed Income Investment, Equity Investment, Real Estate Investment, Alternative Investment, Credit Investment, and Inflation Protection Investment portfolios.

traded investments), the pensions rely upon the general partners of these alternative investment funds to estimate the fair value of the partnership investments.

Contrary to prudent practice for pensions, it appears that neither the State Auditor, the Treasurer nor any independent third party is routinely checking to see if the alternative investment managers, who have an incentive to inflate the values of the portfolios they manage (since their compensation is based largely upon such values), are telling the truth.

While there is disclosure indicating that fair values of certain investments may require significant management judgment or estimation, there is no warning that due to the inherent uncertainty in the valuation of privately-held securities, the fair value may differ from the values that would have been used if a ready market for such securities existed, and the difference can be material.

While there is disclosure indicating that fair value for alternative investments is determined using the best information available for a hypothetical transaction at the measurement date—not using forced sale or fire-sale pricing—there is no warning that in a forced liquidation, under the best of circumstances, TSERS would likely experience a huge discount.

In times of market stress, forced liquidations often occur at discounts as high as 50 percent or more. In other words, the almost $18 billion in risky alternative assets might only be worth half - $9 billion - at a time when TSERS needs the liquidation proceeds most.

Of course, since the investment performance of alternative assets quoted by the pension is based upon appraisals provided by the managers themselves — managers who are subject to a conflict of interest since they are paid largely based upon performance—the

reported performance of these alternative investment funds is inherently as unreliable as the appraisals.

Alarmingly, while it is stated in the CAFR that these alternative investment partnerships and funds are audited annually, the State Auditor does not even review whether any audit of any the alternative funds has been undertaken—much less the quality of the audit. In response to our concerns, we were told that only the Treasurer would know whether the alternative investment funds have all been audited.

In conclusion, in our opinion, the lack of audited financial statements for TSERS is indefensible. The limited financial information regarding TSERS supposedly audited by the State Auditor and included in the voluminous 300-page CAFR is of minimal value and is almost certainly incomprehensible to stakeholders.

Clearly, a stand-alone audit of the $87 billion fund could provide meaningful additional information and would be well worth the limited cost. Our recommendation is that the scope of the stand-alone audit should include the detailed information discussed in this section.

Finally, we found no evidence in the CAFR or elsewhere to suggest that the State Auditor is even aware of the myriad new risks facing TSERS, much less begun to focus upon the emerging critical issues related to alternatives we identified.

IV. Treasurer's Government Operations Reports Violate Current Law

As required under relevant law,[43] on a quarterly basis the State Treasurer provides a report to the Joint Legislative Commission on Government Operations on the investment activities of the State

[43] G.S. 147-68

Treasurer. Periodically—often after months of delay—the so-called "Gov Ops" reports are posted on the Treasurer's website. The reports outline investment activities in summary form for various funds, including, but not limited to, TSERS.

In our opinion, given the disorganization, misstatements and omissions observed, there is simply no way that Joint Legislative Commission on Government Operations, or anyone else for that matter, could possibly monitor or evaluate TSERS investment activity and performance from the information included in the Gov Op reports.

Under the heading Trust Investment Program, total return information is discussed with respect to the Long-Term Investment Fund and the Equity Investment Fund. Contrary to investment industry practice, it is not disclosed whether the total return information is gross or net of all applicable fees and expenses. (The difference between gross and net investment returns is meaningful.) While it is stated that these "two funds comprise the vast majority of the Trust Fund assets," there is no discussion of the growing significant percentage (currently more than 20 percent) of high-risk, high cost hedge, venture, private equity and real estate alternative investments or the performance of such assets.

While Equity Investment Fund 1, 2, 3 and 5 year returns are stated, as well as quarterly index returns, since 1, 2, 3 and 5 year index returns are omitted, it is impossible from this discussion to evaluate the performance of the Equity Investment Fund against a relevant market index**.** The Long-Term Investment Fund total return discussion is similarly flawed.

In our opinion, the incomplete performance information provided in the discussion and other sections in the Gov Ops reports results in concealing significant underperformance against the relevant indexes

that would be readily apparent if complete performance information were provided in the initial narrative section.

While the Combined Statement of Net Position-Trust Funds indicates investments in alternative partnerships as a separate asset class (apparently referring to only private equity and hedge funds) and then lists other real estate, credit and inflation partnerships investments separately, the Statement is misleading in that all such partnerships are considered alternative investments today. Thus, the significant dollar amounts and percentage (more than twenty percent) allocated to alternatives is not effectively disclosed.

Indeed, as mentioned earlier, the Office of the State Auditor indicated to us that it was unaware that alternative investments included real estate, credit and inflation partnerships.

While the Combining Statement of Operations-Trust Funds discloses management fees, it is unclear whether such fees include all asset-based, performance, fund of fund, operating fees and expenses.[44] Further, the significant escalating "other cost" disclosed with respect to each fund is not explained. In our opinion, this way of reporting fees in the Gov Ops reports creates even greater unnecessary confusion.

By way of example, according to the FY 2013 CAFR, total investment expenses amount to $374 million; according to the Gov Ops report, the management fees for the period ended June 30, 2013 are stated as approximately $325 million and other unexplained costs of $41 million. However, as discussed further below, according to information provided to us by the Treasurer, total fees paid in FY 2013 amounted to a far greater figure—approximately $416 million. (As discussed below, even the $416 million figure omits substantial applicable fees and expenses.)

[44] As discussed below, only a small portion of total applicable fees are disclosed.

In conclusion, a reformatted report concerning TSERS specifically is required if Gov Op reports are to serve any useful purpose with respect to TSERS. It is our understanding that few legislators even bother to read the Gov Op reports—which is not surprising given their confusing organization and limited value.

In their current form, the Gov Op reports prepared for the Joint Legislative Commission on Government Operations understate investment fees and expenses, as well as alternative investment percentages, and conceal significant investment underperformance against relevant passive indexes.

Effective August 2013, a new state law, NCGS 147-69.2(b)(10a), mandates full disclosure of all direct and indirect investment management and placement agent fees in her quarterly reports required by NCGS 147-68(d1) to the North Carolina General Assembly Joint Government Operations Committee, the chairmen of the House and Senate Appropriations and Finance committees and the Fiscal Research Division. The Treasurer has failed to supplement the Gov Ops reports with the newly required information. Indeed, as discussed later, she has refused to disclose such information to us, citing confidentiality agreements she has signed with Wall Street money managers.

In connection with our forensic investigation, on March 17, 2014, we reported the Treasurer's violations of NCGS 147-69.2(b)(10a) to State Auditor Beth Wood and asked that her office immediately investigate.[45]

V. Treasurer's Other Financial Reports Confuse and Conceal Underperformance

[45] Investigator calls for North Carolina state auditor to look into alternatives fees, Pensions & Investments, March 17, 2014.

Investment Performance Reports: On a quarterly basis, the Treasurer's office posts on its website so-called investment performance reports for TSERS. These one-page reports simply indicate performance of the various funds, i.e., Global Equity, Fixed Income, Real Estate, Alternatives, Credit, Inflation, and Total Pension Plan, over the quarter and other longer periods, as well as the percentage of assets allocated to each fund.

Again, categorizing the private equity and hedge fund investment fund as "alternatives" and not indicating that real estate, credit and inflations assets are also considered alternatives, is both misleading and inconsistent with current industry practice.

Each fund and the total pension are compared against an unidentified, unexplained apparently "custom" benchmark. In our opinion, absent disclosure of the composition of the custom benchmarks and unaccompanied by independent standard industry benchmarks, such as S&P 500, the performance information provided is confusing, unverifiable, incomplete and misleading to the public.

Even though these reports reveal outrageous short and long-term underperformance related to the real estate and alternatives funds against the custom benchmarks, in our opinion, if standard industry benchmarks were included, far greater underperformance would be readily apparent.

As a result, the quarterly investment performance reports as prepared by the Treasurer's Office are of minimal value, fail to adequately disclose TSERS performance to the public and, in fact, conceal even greater underperformance than the massive shortfalls revealed.

Pension Press Releases: On a quarterly basis, the Treasurer issues a press release announcing returns for the past quarter and other periods,

such as calendar year or fiscal year, as well as for the various portfolios or funds. A link to the flawed summary performance reports discussed above is provided by the Treasurer in each release. The commentary in each press release touts the reported performance and cites other favorable events; however, there is no candid disclosure of chronic underperformance against custom benchmarks or other problems.

For example, an August 8, 2013 press release states, “I am pleased that we reached a 9.52 percent return, which beats our target. This is good news as we secure the retirement for thousands of North Carolina families,” Cowell said. “At the same time, the stock market is volatile and fixed income presents a long-term challenge. That’s why I am glad the legislature granted additional investment flexibility so that we can take advantage of growth opportunities like credit and real estate.” There is no mention that the real estate fund had massively underperformed the custom benchmark on a 1, 3, 5, 10 and 15 year basis.

There simply was no reasonable basis for asserting that greater real estate investment will improve performance.

A May 13, 2013 release quotes the Treasurer saying, “It has become even clearer that fixed income assets in bonds are underperforming and will create a drag on our fund. It is critical that our investment professionals have the flexibility to navigate these markets." In fact, other than the most recent quarter, the fixed income assets had consistently outperformed the custom benchmark on 1, 3, 5, and 10 year basis. Indeed, the Treasurer’s Annual Report-Fiscal Year 2011-2012 refers to “strong results” in fixed income.”[46]

[46] Page 41.

In short, the information regarding TSERS investment performance in press releases is nuanced to support the Treasurer's political objectives such as increasing pension exposure to high-risk, high-cost hedge, venture, private equity and real estate alternative investments; however, the press release information materially misrepresents investment realities and, because it is misleading should not, in our opinion, be relied upon by the public.

Annual Investment Reports: For Fiscal Years 2007-2008; 2008-2009; and 2009-2010, Annual Investment Reports are posted on the Treasurer's website.

For Fiscal Year 2007-2008, the last year of the former Treasurer Richard Moore's tenure, an Annual Investment Report, separate from the Annual Report discussed below, was created in an effort "to increase the amount and quality of information made available to the public regarding pension investment matters."

The Annual Investment Report included new information, such as a discussion of the investment portfolio; spreadsheets disclosing assets under management; fee and performance information by individual manager; and appendices disclosing schedules of equity and fixed income holdings.

For Fiscal Year 2008-2009, the first of Janet Cowell's tenure, the Annual Investment Report consisted of the Investment Management section from the Treasurer's Annual Report, supplemented by spreadsheets disclosing assets under management; fees and performance by individual manager; and appendices listing fixed income and equity portfolio holdings.

For Fiscal Year 2009-2010, the Annual Investment Report posted on the Treasurer's website consists merely of the entire Annual Report (not the

Investment Management section as stated); additionally, for whatever reason, the spreadsheets disclosing assets under management; fee and performance information by individual manager are not included. Thereafter, no Annual Investment Reports have been posted.

In conclusion, the amount and quality of information made available to the public regarding certain significant pension investment matters, such as fees and investment performance by manager, has deteriorated under the current Treasurer.

As TSERS has increased the percentage of assets managed by high-risk, high-cost hedge, venture, private equity and real estate alternative investment managers and the impact of fees upon net investment performance has dramatically increased, disclosure by the Treasurer of assets under management, fee and performance information, by individual manager, has inexplicably vanished.

Department of State Treasurer Annual Report: Department of State Treasurer Annual Reports are created for each fiscal year and posted on the Treasurer's website. Limited unaudited information regarding the pension is included within the lengthy Annual Reports; as a result, the information is far more difficult for the public to find and review than if included in a separate comprehensive audited report of the pension. In addition, as discussed below, the pension information in the Annual Report conflicts with information provided by the Treasurer in other pension reports.

In the 108-page Fiscal Year 2011-2012 Annual Report, approximately 26 pages relate to TSERS investments. While the Annual Report discloses assets under management by individual manager, fee and performance information by individual manager (which, for a brief period, was provided in the Annual Investment Report, as indicated above) is omitted.

The information regarding managers and TSERS assets under management provided in the Annual Report is useless for purposes of evaluating managers without individual manager fee and performance information.

Under Operating Policy, it is stated that within the pension fund, assets are divided into various classes of investments as defined in a chart below.[47]

The chart indicates both Hedged Strategies Investment Portfolio and Private Equity Investment Portfolio as classes of investments into which pension assets are divided. Note that neither the CAFR, Gov Ops reports, nor the Investment Performance reports refer to any Hedged Strategies Investment Portfolio or Private Equity Investment Portfolio.

There is no separate discussion of the Hedge Fund Strategies Investment Portfolio in the Annual Report; rather the only hedge funds mentioned are included in the discussion of Credit Strategies. It is indicated that hedge funds represent 63.4 percent of the approximately $3.1 billion invested in Credit Strategies, representing 4.2 percent of the pension fund.

The chart also states the Hedged Strategies Investment Portfolio is managed by hedge fund of funds.[48] It is impossible to ascertain from the

[47] The chart indicates that all portfolios are managed by "experienced investment advisors," except the Fixed Income Investment Portfolio. Fixed Income is internally managed—hopefully by experienced investment professionals; however, the chart neglects to state such.

[48] It also appears that the Global Equity Portfolio includes at least one fund of funds or manager of managers, a $130 million investment in Tiger Tar Heel Partners.

Annual Report which managers are hedge fund managers or hedge fund of fund managers.[49]

This is yet another example of confusion created by the division of assets at TSERS and the failure to clearly disclose the extensive use of alternative investments.

The Fiscal Year 2010-2011 Annual Report included a discussion of Hedged Strategies, including a list of seven funds of funds in which TSERS had invested $431.6 million. The overwhelming majority of these assets ($357 million) were invested with Franklin Street Partners.

As indicated in the 2010-2011 Annual Report, the long-term investment performance of the Hedge Strategies Investment Portfolio was **horrendous** — 1.6 percent versus 6 percent for the custom benchmark. While Franklin and most of the other hedge fund of fund managers continued to manage TSERS assets through the end of 2013, the names of these firms and the amount of TSERS assets they manage, vanished from the 2011-2012 Annual Report without explanation.

In the Annual Reports, the performance of the total plan and the various investment portfolios is disclosed, compared against custom benchmarks. Unlike the Investment Performance reports produced by the Treasurer that cite custom benchmark without definitions, here there is footnote disclosure detailing the complex components of the custom benchmarks — the appropriateness and accuracy of which are impossible to verify.

Highly subject to manipulation and apparently frequently changed by the Treasurer, the custom benchmarks are incomprehensible to all but the most seasoned investment professionals. No well-recognized

[49] It is also impossible to determine which of the private equity and other funds are, in fact, fund of funds.

benchmark indexes, such as the S&P 500, are included in the performance reporting.

Alternative asset classes—real estate, private equity and hedged strategies all indicate **severe long-term underperformance**. Traditional asset classes—global equity and fixed income have performed competitively against the custom benchmarks. These performance realities starkly contrast with statements by the Treasurer indicating that TSERS traditional assets have underperformed and greater alternative assets will improve performance in the future.

With respect to the long-term atrocious performance of real estate against the custom benchmark, the Annual Report summarily states that "benchmark issues are an industry-wide problem" and there is discussion of replacing the problematic benchmark with a new benchmark. In other words, the benchmark is blamed, not the poor performing managers.

With respect to the long-term dismal private equity performance against the custom benchmark, again the custom benchmark, not the managers is blamed. Despite the fact that a new more-forgiving private equity benchmark was adopted in 2011, replacing what had been a public equity benchmark (Russell 3000 Index lagged 3 months plus 250 basis points) short and long-term performance still significantly lagged the new benchmark.

There is no explanation of hedged strategies underperformance and no disclosure of the name of the hedge funds—they have simply vanished.

In summary, the use of multiple hedge fund of funds with horrendous long-term performance as revealed in the 2010-2011 Annual Report is disturbing enough; worse still is the removal of disclosure regarding these assets and managers in the subsequent Annual Report. Further,

TSERS has invested in numerous other funds of funds which are not properly disclosed and raise similar concerns.

VI. A History of Pension Pay-for-Play Abuses

Repeated allegations of improper pay-to-play payments by money managers and other vendors retained by TSERS first emerged in 2005 when then-State Treasurer Richard Moore was criticized for asking money managers who did business with the pensions to contribute to a nonprofit foundation he started to help state residents better manage their finances. Moore reportedly said at the time that this wasn't a conflict of interest.[50]

An early 2007 Forbes article titled "Pensions, Pols, Payola" focused upon another form of pay-to-play, i.e., political campaign contributions by investment managers and others to the State Treasurer.[51] The article noted that under Moore, the fees paid to TSERS money managers "jumped six-fold, to $116 million in the year through June 2006. All told, over half the state's fees, or $63 million, went to firms that manage just 6.3% of its assets: hedge, private equity and real estate funds. These same firms were disproportionately large contributors to Moore's campaign."[52]

Allegations of improper payments by TSERS managers again surfaced in 2009 when the state's chief pension investment officer, Patricia Gerrick,

---

[50] In Fundraising Concerns Surround Ousted Treasury Official, North Carolina Journal, September 26, 2009.

[51] Forbes, February 23, 2007.

[52] The article also noted that Moore's office, in each of his six years as Treasurer, failed to provide the state legislature with a state-mandated annual report detailing his managers' results. As a result, it was impossible for the public to assess whether the performance of the individual managers justified the higher fees paid for active management. "Moore's state Web site posts sparse details, mostly from 2005 or earlier; it does not disclose the names of the money managers he hires or their fees."

was reportedly terminated for soliciting donations on behalf of a local charity.[53]

In 2012, campaign donations to the Treasurer from class action law firms retained by TSERS surfaced as a controversial issue.[54]

Further, recent disclosures by the Treasurer confirm that at least since 2002, TSERS investment managers have been involved in another form of potential pay-to-play, i.e., paying compensation to secret placement agents that may not be properly registered under the federal securities laws. As discussed further below, the identity of all of the agents, their registration status and the amounts of the compensation paid, while known to the Treasurer, remain undisclosed to this day — despite recommendations by investment and legal experts retained by the Treasurer to fully disclose.

Most recently the Treasurer has failed to comply with a new state law, NCGS 147-69.2(b)(10a),which mandates full disclosure of all direct and indirect investment management and placement agent fees in her quarterly reports required by NCGS 147-68(d1) to the North Carolina General Assembly Joint Government Operations Committee, the chairs of the House and Senate Appropriations and Finance committees and the Fiscal Research Division, citing confidentiality agreements she has signed with Wall Street money managers.

---

[53] Fundraising Concerns Surround Ousted Treasury Official, North Carolina Journal, September 26, 2009. New Questions Surround Treasury Official and Fund Managers, October 12, 2009. Ex-investment officer defends her ties to fund managers, October 12, 2009, WRAL.

[54] Donations to State Treasurer Raise Red Flags, October 2, 2012 by Brian Balfour, Corruption & Ethics, Civitas Institute.

In connection with our forensic investigation, on March 17, 2014, we reported the Treasurer's violations of NCGS 147-69.2(b)(10a) to State Auditor Beth Wood and asked that her office immediately investigate.[55]

VII. Flawed Sole Fiduciary Governance Structure

As mentioned earlier, the Treasurer is the sole fiduciary of TSERS funds. Along with Connecticut, Michigan, and New York, North Carolina is one of only four states with a "sole fiduciary" model for managing its public pensions.

All other states vest the fiduciary duty to oversee their retirement assets in a committee generally consisting of worker and retiree representatives, state officials and appointed members of the public, as opposed to a single individual.[56]

There is longstanding, broad national consensus that the sole fiduciary structure is deeply flawed. It is widely acknowledged that a committee of fiduciaries can enhance accountability and reduce the risk that the investment-making process may be compromised by a threat to the independence of a single individual.

Worse still, in all states mentioned above, the sole fiduciary is the publicly-elected state comptroller or treasurer. Not surprising, allegations of corruption of investment decision-making as a result of political contributions, called "pay-to-play" have surfaced repeatedly in

---

[55] On this same date SEANC issued a press release calling on the Treasurer "to show transparency and accountability by immediately disclosing all of the retirement fees as the current law requires her to do."

[56] Generally, state retirement boards are not required to consist of trustees possessing any specific investment experience. Further, in our opinion, experience in the investment industry is often detrimental because industry insiders often fail to recognize that common industry practices are frequently inappropriate in the public pension context.

Connecticut, New York and North Carolina. Where the committee of fiduciaries structure is adopted and a single elected official no longer controls pension decision-making, the risk that Wall Street political giving may undermine investing operations is significantly reduced.

As New York Governor Andrew Coumo stated in 2009 in support of a bill to eliminate the state pension's sole fiduciary structure, "For decades, the State pension fund has been weakened and corrupted by the sole trustee model. It's about as sensible as having a single lock on Fort Knox. Today's legislation will ensure that the fate of our public retirement fund isn't decided by one individual, and that the entire system is rid of the kind of pay-to-play that infected and derailed it in the first place."[57]

Shortly after the Treasurer took office, she commissioned a supposedly Independent Review and Evaluation of the North Carolina Retirement Systems by the investment consulting firm then-called EnnisKnupp which made repeated mention of the sole fiduciary structure, as well as the fact that only three other states had the sole fiduciary model, but made no recommendation that the structure be eliminated in North Carolina in 2010.[58]

The failure to address this pressing issue is all-the-more surprising given that the few remaining sole fiduciaries—in Connecticut, New York and North Carolina—were embroiled in controversy at this very time.

At this approximate time in 2010, Benchmark was engaged in an investigation of Aon, EnnisKnupp's parent company, regarding undisclosed payments from a third party for endorsing its retirement-plan offering to its union membership. An Aon consultant working for

[57] It's About Time: NY To Abandon Sole Fiduciary, Reuters PE Hub, October 8, 2009. Note: New York has yet to abandon the sole fiduciary structure.

[58] Independent Review and Evaluation of the North Carolina Retirement Systems, EnnisKnupp, April 19, 2010.

the union wrote in a candid email uncovered during the investigation, "I couldn't think of a politically correct way to word the kick-back item–thought you might want to take a crack at that."[59]

We note that, according to Forbes, Hewitt EnnisKnupp is subject to myriad conflicts of interest, for which the firm has been publicly criticized. As stated in a 2010 article, "Is ''Conflict-Free'' EnnisKnupp Selling Its Soul?" both Hewitt and Aon have securities broker-dealer affiliates which underwrite mutual funds and sell private placements.[60]

Below are but a few of the disturbing conflicts of interest discussed in the firm's current SEC filings[61] which may, in our opinion, undermine the independence of the advice provided by Hewitt Ennisknupp:

- A number of investment management firms the firm may recommend to its clients are clients of Aon and/or its subsidiaries, including Aon Hewitt.

- The firm may provide investment consulting services to the benefit plans of investment management firms whose funds it may recommend to its clients.

- Certain employees of the firm hold securities licenses with Aon Benfield Securities, Inc., a registered broker-dealer, which is an

---

[59] Based upon our findings, in 2010 Nationwide Retirement Solutions entered into a $16 million settlement with Alabama State Attorney General Troy King.

[60] Is ''Conflict-Free'' EnnisKnupp Selling Its Soul? August 23, 2010.

[61] http://www.adviserinfo.sec.gov/Iapd/Content/Common/crd_iapd_Brochure.aspx?BRCHR_VRSN_ID=215668

indirect subsidiary of Aon. Interests in the Aon Hewitt Group Trust are offered through Aon Benfield Securities, Inc.[62]

In our opinion, whether conflicts of interest at EnnisKnupp are adequately disclosed in its SEC filings should be investigated more fully by the SEC.

More recently, in a 2013 Special Review commissioned by the Treasurer and conducted by Kellogg, Huber, Hansen, Todd, Evans & Figel, the law firm indicated that its review suggested that "there had been times, prior to Treasurer Cowell taking office, when the discretion granted to the Treasurer appeared to have been unduly influenced by dealings with third parties." There was no reference to any allegations of undue influence related to the current Treasurer.

The law firm recommended that the North Carolina legislature establish an Investment Committee comprised of experienced investment professionals to be involved in fiduciary decisions regarding the selection of investments for TSERS and that the Investment Committee should be vested with the fiduciary duty that currently is committed to the Treasurer.[63]

While such a recommendation might seem to promote accountability, tellingly it was accompanied with a recommendation to eliminate transparency.

The law firm stated that it believed that public disclosure of the Investment Committee's deliberations could threaten the independence

---

[62] Benchmark also investigated conflicts of interest at Hewitt Associates in connection with a fiduciary breach investigation of the U. S. Airways Pilots Pension plan in 2012.
http://www.benchmarkalert.com/US_Airways.pdf

[63] Special Review for the North Carolina Department of State Treasurer, December 11, 2013, page 7.

of those deliberations and create a risk of adverse consequences to members of the Investment Committee and to third parties whose investments may be under consideration. Thus, they believed its deliberations should be exempt from North Carolina Open Meetings Law, N.C. Gen. Stat. § 143-318.10, requiring public disclosure of the Investment Committee's deliberations.[64]

In our opinion, while it is indisputable that the sole fiduciary structure should have been the premier priority once the Treasurer took office (given the history of abuses), replacing it with an Investment Committee comprised of experienced investment professionals operating in secrecy—an arrangement riddled with potential conflicts of interest, utterly lacking transparency and accountability—is outrageous and blatantly disingenuous.

Public pension reform and secrecy are, in our opinion, fundamentally incompatible.

In January 2014, the Treasurer announced the creation of a supposedly independent, bipartisan commission and hand-picked its member to review the state's governance structure for investment management. Again, the Treasurer has retained the consulting firm of EnnisKnupp (now called Hewitt Ennisknupp- An Aon Company) to provide supposedly objective advice.

The Investment Fiduciary Governance Commission established by the Treasurer, which is expected to makes its recommendations to the Treasurer and the General Assembly by April 30, will look at the sole fiduciary structure and whether it should be replaced with an investment advisory committee model.

[64] Id.

We believe the initial matters any such Committee should immediately focus upon are the secrecy surrounding alternative investments and placement agents; the serious potential violations of law detailed in this report and, finally, the Treasurer's motivations and actions related thereto.

VIII. TSERS' Escalating High-Risk Alternative Investment Gamble

TSERS' escalating historic costly, high-risk gamble on alternative investments began more than a decade ago in 2001. Allegations of impropriety relate back to inception of the strategy. Remarkably, despite recurring controversies and allegations of corruption surrounding the former and current state treasurers over the years, as well as periodic reporting of horrific performance, the state pension has continued to dramatically increase its allocation to alternatives from 0.1 percent to 35 percent today, adding tens of billions to these costly schemes that provide no benefit to TSERS.

Shortly after Richard Moore was elected Treasurer in 2000, he persuaded the state legislature to increase the portion of the pension fund invested in hedge and private equity funds from 0.1 percent to 5 percent.

As reported in Forbes,[65] in support of that effort was Eugene McDonald, former manager of Duke University's endowment, who wrote a paper on it and was a member of Moore's five-person investment committee. After Moore was granted wider latitude to invest in alternatives, he invested $400 million in Quellos Asset Management, a private equity fund of funds. McDonald was Quellos' investment chief.

[65] Pensions, Pols, Payola, February 23, 2007.

Moore, said Forbes, “stuck with Quellos after it was slammed in 2005 for flogging tax shelters that the U.S. Senate declared ‘a bowl of spaghetti.’ Cost to U.S. taxpayers: $300 million.”

In 2007, BlackRock bought Quellos’ fund of funds business[66] and TSERS still remains an investor in the BlackRock CARS hedge fund of funds to this day.

Seven years ago, Forbes noted the confluence of political contributions related to TSERS significantly underperforming alternative investments.

“Quellos says it has returned “superior results,” but in fact it earned North Carolina a middling 7% annually (versus 11% for the S&P 500) the past three years. It reaped $6.1 million from Moore’s office last fiscal year. Quellos execs, including McDonald, have contributed $16,000 to Moore’s campaign.”

Also according to Forbes, “Moore’s investment chief, Andrew Silton, went part-time in 2003 and picked up work with Franklin Street Partners. Moore has $400 million invested with this Chapel Hill, N.C. hedge fund and paid it $5.5 million in the last fiscal year. Moore took in $15,000 from Franklin Street officials.”

As discussed later in this report, Franklin Street Partners, another hedge fund of funds manager based in North Carolina (which does not actually manage money itself), continues to manage significant TSERS assets. It appears that TSERS today is the sole investor in the Franklin hedge fund of funds and over the years has been at least a primary investor. Further, if appears that TSERS may have substantially seeded Franklin’s fund of funds.

Said Forbes, “Tracking Moore’s results is difficult. The state auditor found in 2005 that 40% of his high-risk fund managers ran 6 to 18

[66] BlackRock to buy Quellos fund of funds business, Reuters, June 26, 2007.

months late supplying returns data. One data set, though, shows they are trailing behind industry benchmarks: In five years hedge and private equity funds returned 2.3% annually for the state against a benchmark of 7.7%, real estate funds 10.5% versus the benchmark 11.9%."[67]

In spite of longstanding severe underperformance, the flawed alternative investment strategy, has continued and expanded. Most often, the past and current Treasurer's justification for increasing alternatives has been the greater returns than traditional investments offer — returns that repeatedly fail to realize.

In 2009 and 2010, even after the current Treasurer had received additional legislative authorization for allocations to two new asset classes (5 percent credit and 5 percent inflation), the State Auditor determined that the Treasurer had exceeded the 5 percent statutory limit on alternatives. [68]

In 2011, the Treasurer again sought authorization from the legislature to increase the alternative allocation from 5 percent to 10 percent and create a new 10 percent of global equity allocation to unregistered long-short public equity hedge funds. The legislature granted permission for 7.5 percent in alternatives and 6.5 percent in unregistered long-short public equity hedge funds. Thus, by 2011, the permissible limit for all alternatives, including real estate, had mushroomed to 34 percent.

In 2013, the Treasurer once again sought to increase the overall allocation to various alternative classes to a maximum of 40 percent. The Treasurer claimed that "the new flexibility to invest in hedge funds,

[67] Pensions, Pols, Payola, February 23, 2007.

[68] It should be noted that throughout this period TSERS was authorized to invest 10 percent of its portfolio in real estate which is considered an alternative investment today.

commodities and asset-backed alternative investments won't guarantee the state can meet its returns, but 'we'd have a fighting chance.'"[69]

However, due to growing concerns regarding the related risks, the Treasurer was only granted an overall increase of 1 percent to 35 percent. Further, as an added safeguard the Treasurer was required in the enabling legislation to disclose in her quarterly Government Operations reports to the North Carolina General Assembly all direct and indirect placement fees, asset fees, performance fees and any other money management fees incurred by the State in the management of TSERS.[70]

As discussed elsewhere in this report, there is no evidence that the Treasurer has complied with applicable law by providing in any Government Operations report any such specific listing of all indirect and indirect placement agent and asset management fees.

IX. Treasurer's "Experiment" Fails: A Decade of Soaring Investment Fees to Wall Street Has Not Improved Performance

Early on in her tenure, the Treasurer defended shifting more and more pension assets to alternative managers, arguing that the hundreds of millions in additional fees to Wall Street would result in improved investment performance.

"We'll be looking for if we're paying higher fees for investments they better be performing and giving us a higher rate of return. Otherwise, it's a failed experiment," Cowell said.[71]

---

[69] Cowell wants more flexibility to invest pension fund, newsobserver, June 26, 2013.
[70] NCGS 147-69.2(b)(10a)

[71] Outside managers mean higher fees for N.C.'s pension fund, WRAL.com, April 26, 2010.

The Treasurer’s candid admission that the TSERS historic high-risk gamble on alternative investments amounting to 35 percent of $87 billion, or over $30 billion, is an “experiment” is startling. The Treasurer should not be experimenting with tens of billions in state workers retirement savings; rather, as the sole fiduciary, she should be focused upon investing pension assets prudently.

However, even as of this date in 2010, the costly alternative investment experiment had already spectacularly failed — it had been severely underperforming for approximately eight years.[72]

Cowell stated in 2010 that the “experiment is on a seven-to-ten-year cycle, and performance and fees will be weighed over that time frame.”[73]

Twelve years after inception in 2002, the Treasurer’s alternative investment “experiment” continues to spectacularly fail — costing the pension dearly and benefiting only Wall Street.

Most important, there is no proof that alternative investments beat the market, as the Treasurer has claimed. Indeed, possibly the world’s greatest investor, the Oracle of Omaha, Warren Buffet, six years ago wagered $1 million that hedge funds would not beat the S&P 500 over the next ten years. At this point Buffet is still handily winning.[74]

---

[72] As noted by Forbes back in 2007, “In five years hedge and private equity funds returned 2.3% annually for the state against a benchmark of 7.7%, real estate funds 10.5% versus the benchmark 11.9%”.Pensions, Pols, Payola, February 23, 2007.

[73] Id.

[74] “At the end of 2013, Vanguard's Admiral shares -- the S&P index fund that's carrying Buffett's colors -- were up for the six years that began Jan. 1, 2008 by 43.8%. For the same period, Protégé Partner’s five funds of funds, on the average, gained only by an estimated 12.5%...” Buffett widens lead in $1 million hedge fund bet, Fortune, February 5, 2014.

The North Carolina state pension is not.

Bloomberg Businessweek's provocative cover story "Hedge Funds Are for Suckers," on July 11, 2013, discussed reversals of fortunes involving many leading hedge fund managers. Further, the magazine noted that eight of the last 10 years simple, low-cost index funds have outperformed hedge funds.

According to the authors of a recent Maryland and 49 Other States study of state pensions:

"To try and compensate for the fact that "beating the market" is difficult with publicly-traded securities, many public pension funds have increased their exposure to alternative investment managers, who claim a "secret sauce" that allows them to beat the public markets consistently. However, there is no scientific evidence to support such a notion. Many alternative managers buy and sell publicly traded securities (i.e., "hedge funds"), so this idea is simply "old wine in a new bottle."

Furthermore, the private equity industry has yet to offer proof that private equity consistently beats the relevant public equity market index, after fees…

Complicating Private Equity performance measures is the fact that many leveraged buyouts from the pre-crash period have yet to sell, and the state pension systems rely on the buyout funds' in-house valuation of such investments to determine the systems' own investment returns. The states exercise limited supervision over the buyout funds, and examination of buyout fund portfolio values by buyout fund independent certified public accountants is less than rigorous."[75]

X. Billions in Underperformance To Date - Worst Yet to Come

In stark contrast to recent statements by the Treasurer that the additional investment flexibility granted by the legislature to permit TSERS to increase alternative investments will improve performance, the

[75] Wall Street Fees, Investment Returns, Maryland and 49 Other State Pension Funds by Jeff Hooke and John J. Walters, July 2, 2013.

investment performance history reveals that TSERS's alternative investments (and the pension as a whole), have performed poorly.

A recent report by Hewitt EnnisKnupp, clearly states that "the relative performance of TSERS's traditional asset classes when compared to their benchmarks has been strong. The performance of TSERS's Real Estate, Private Equity, and Hedge Fund asset classes has been weak relative to their primary benchmarks."[76]

For the past one, three and ten fiscal years, TSERS has significantly underperformed the peer group benchmark it has adopted for evaluating its performance, the BNY Mellon Public Fund Universe for public funds with assets greater than $1 billion.

Total TSERS underperformance gross of fees for the past five calendar years amounts to **$6.8 billion.**[77]

Based upon the TSERS investment track record, it is highly likely, in our opinion, that increasing the allocation to high-cost, high-risk alternative investments that have consistently underperformed will result in billions greater performance losses and approximately $90 million in additional disclosed fees paid to Wall Street money managers according to the Treasurer's estimates.[78]

While Wall Street is certain to emerge as a winner under the Treasurer's strategic investment plan, the stakeholders will, in our opinion, lose ever greater amounts due to rapidly escalating fees and plummeting net investment performance.

[76] Investment Fiduciary Governance Commission Briefing Book, January 23, 2014, page 38.

[77] IMD Performance Review, Investment Advisory Committee Meeting, February 19, 2014.

[78] Id.

XI. The Myth That Alternative Investments Provide Diversification and Reduce Risk

As the investment performance of TSERS has continued to lag behind its peers under the new mix of assets adopted at the Treasurer's recommendation that relies more heavily on alternatives, the Treasurer has claimed TSERS will benefit over time because of a reduction in the risk and volatility of the pension's portfolio as a result of alternatives.[79]

"Hedge funds, which are unregulated pools of private capital, have come to stand for taking greater risks — at least that the general perception. But Vail (Cowell's spokeswoman) counters that pension officials will seek to use the hedge strategy as a way to "reduce risk wherever authorized."[80]

However, the argument that high-cost, high-risk alternative funds reduce risk or provide diversification is deeply flawed. Again in the words of the authors of the Maryland study:

'When questioned about the unproven return history of alternative assets, public pension funds' officials and investment consultants typically respond, "Mediocre performance may be true, but alternatives allow diversification out of public equity and public fixed-income markets." This statement shows a lack of understanding about alternatives. Hedge funds, as noted, principally invest in publicly-traded securities…

Private equity funds, in contrast, acquire mainly securities in privately-owned corporations. The underlying issuers of such private securities have economic attributes that are similar in many ways to their publicly-traded counterparts.

---

[79] N.C. pension manager eyeing bigger returns in hedge funds, Charlotte Business Journal, February 17, 2012.

[80] Id.

That's hardly diversification."[81]

Further, while the massive underperformance of the alternatives at TSERS is apparent at this time, amounting to almost $9 billion, the amount of any potential downside protection afforded by the alternatives is unproven and unknown.[82]

Thus, it is impossible to assess whether the massive cost related to any supposed risk reduction is reasonable.

XII. Massive Risk, Fiduciary Breaches and Potential Illegalities Revealed in Alternative Investments Documents

In order to assess the risks, potential fiduciary breaches and violations of law related to the hundreds of alternatives owned by TSERS, we reviewed the private placement offering memoranda related to certain of these investments.

A few of the offering documents we reviewed were provided by the Treasurer in response to our public records request. Other information the Treasurer refused to provide we obtained from independent sources.

While the Treasurer refused to disclose the overwhelming majority of these memoranda and other documents related to the alternatives we requested to the public, claiming that the documents contain proprietary business information or "trade secrets," it should be noted that thousands of copies of these offering documents have been

[81] Id.

[82] The average hedge fund lost 18 percent of its value in 2008, the industry's worst performance and roughly 10 percent of hedge funds shut down in 2008. Hedge Funds Took A Serious Hit in 2008, CBS Money Watch, October 14, 2010.

distributed by the funds' investment managers to existing and prospective investors, as well as influential intermediaries, such as investment consultants and financial advisers.

As discussed more fully below, certain of the offering memoranda indicate that investors will not receive complete information regarding investment strategies and portfolio investments. Thus, it may be that the Treasurer has agreed to permit the managers to not provide any of the fundamental information we and others have requested regarding these investments — information which she, as the sole fiduciary to the pension — should be carefully reviewing.

1. Alternatives Are High Risk, Speculative Investments

The private placement memoranda and other documents related to TSERS' alternative investments generally prominently state (in capital, bold lettering) that an investment in the fund is speculative, involves a high degree of risk, and is suitable only for persons who are willing and able to assume the risk of losing their entire investment.

In summary, it is indisputable that TSERS investments in alternative funds involve far greater investment risk (as opposed to integrity or operational risk) than traditional investments.

2. Illiquidity Risk

The alternative funds' portfolio holdings invested in private companies generally are in the form of securities that are restricted as to resale pursuant to federal and state securities laws. Even if sales of such securities may be affected without violating such securities laws, no public market for such securities exists. Also, the funds may be prohibited by lock-up agreements from selling certain portfolio securities for a certain period of time. Therefore, the assets of the funds

are substantially illiquid, and investors may not be able to liquidate their investment in the event of emergency or for any other reason.

Investments in alternative funds themselves are also highly illiquid. The interests in the funds are not registered under the Securities Act of 1933, the securities laws of any state or other jurisdiction, and therefore, cannot be resold. There is no public market for the interests in the funds and none is expected to develop. In addition, there are restrictions in the partnership agreements regarding the transferability of the interests and there is a prohibition on limited partners' withdrawing from the funds. Limited partners may not be able to liquidate their investment for any reason and must be prepared to bear the risk of owning the interests for an extended or indefinite period of time.[83]

3. Rampant Conflicts of Interest and Self-Dealing Opportunities

The private placement memorandum and other documents related to TSERS' alternative investments generally prominently state (in capital, bold lettering) that the offerings involve various serious conflicts of interest between the funds and the managing partners and their affiliates.

For example, the manager or its affiliates may make proprietary investments for its own account in the very same entities or assets in which the funds invest on more favorable terms and at the expense of investors in the funds, including TSERS. Alternatively, in the event that an investment opportunity is available in limited amounts, the manager may simply allocate the entire investment opportunity to its affiliate.

[83] See, for example, Chapter IV Investors Special Situations Fund, L.P. Confidential Offering Memorandum, July, 2006; Aurora Venture V, L.P., Amended and Restated Confidential Private Placement Memorandum.

The Fortress Credit Opportunities Funds III, Confidential Offering Memorandum warns, “This may lead to fewer, and less attractive, investment opportunities being made available to the funds than would have been the case had the affiliates been restricted from pursuing proprietary investments.” [84]

Further, the manager generally determines the value of the assets held by the fund. Such valuation affects both reported fund performance as well as the calculation of the management fee and any performance fee payable to the manager. The investment managers are subject to a conflict of interest because they can profit from inflating values.

Finally, the performance fee structure creates an incentive to the investment manager to engage in speculative investments and increase the use of leverage, as well as the timing and realization of investments. Thus, a potential conflict exists with the interests of the investors.

While Fortress and other TSERS’ alternative managers may generally disclose the existence of these conflicts of interest and opportunities for self-dealing, in our opinion, incomplete disclosure with respect to such serious breaches of fiduciary duty may not be effective under applicable state or federal law — particularly with respect to pensions safeguarding state workers’ assets.

Accordingly, we recommend immediate further investigation of such potential breaches and a referral to the SEC.

4. Mystery Investors Granted Licenses to Steal

It is common for alternative funds to withhold from investors detailed disclosure of the composition of their investment portfolios.

[84] See Fortress Credit Opportunities Funds III, Confidential Offering Memorandum, June 2011, page 36.

Hedge fund offering documents often include the following language: "In an effort to protect the confidentiality of its positions, the Fund generally will not disclose its positions to shareholders."

The offering document disclosure may further warn: "As the investment advisor's investment system is proprietary, the shareholders will not have the objective means by which to evaluate its operation or to determine whether it is being followed. Further, the shareholders may not have the ability to review the investment positions of the Fund."

In summary, as a condition to investing in alternative funds, the Treasurer, as the sole fiduciary to TSERS may be required to consent to being kept in the dark, abrogating her duty to monitor and safeguard pension assets.

Of even greater concern, the hedge fund managers routinely matter-of-factly state that they are not required to provide the *same type or level of disclosure* regarding investments and strategies *to all investors*. Certain mystery investors may invest on terms that provide access to information that is not generally available to other investors and, as a result, may be able to act on such additional information (e.g., request withdrawal of their monies) that other investors do not receive.

According to one manager we reviewed elsewhere, "The General Partner may in its absolute discretion agree to provide certain strategic investors in the Partnership with information about the Partnership and its investments which is not available to investors generally."

Another manager says, "The Fund has entered and may enter into side letters and other agreements and arrangements with certain investors pursuant to which, among other things, an investor may receive reports and have access to information regarding the Fund's portfolio that might not be generally available to other shareholders. Such investors may be

able to base their investment decisions, including, without limitation, redeeming their Shares from the Fund, on information that is not generally available to other shareholders."

Yet another manager elaborates, "The Partnership and the General Partner may from time to time enter into agreements with one or more Limited Partners whereby in consideration for agreeing to invest certain amounts in the Partnership and other consideration deemed material by the General Partner, such Limited Partners may be granted favorable rights not afforded to other Limited Partners or investors, generally. Such rights may include one or more of the following: special rights to make future investments in the Partnership and/or the Other Accounts, as appropriate; special withdrawal rights, relating to frequency, notice and/or other terms; rights to receive reports from the Partnership on a more frequent basis or that include information not provided to other Limited Partners (including, without limitation, more detailed information regarding positions); rights to receive reduced rates of the Incentive Allocation and/or Management Fee; rights to receive a share of the Incentive Allocation, Management Fee or other amounts earned by the General Partner or its affiliates; and such other rights as may be negotiated between the Partnership and such Limited Partners. The Partnership and the General Partner may enter into such agreements without the consent of or notice to the other Limited Partners."

In other words, TSERS may have directly or indirectly through funds of funds consented, for unimaginable reasons, to managers permitting other mystery investors in the alternative funds to profit at its expense — effectively granting a license to steal from the state pension to these unknown investors. The identity of the privileged "strategic" investors profiting from public pensions is not disclosed. The managers are not even required to notify TSERS that other investors receiving greater information exist.

In summary, the hedge and other alternative fund offering documents often reveal that investors, such as TSERS, agree to permit the managers to withhold complete and timely disclosure of material information regarding pension assets in their funds. Further, TSERS agrees to permit the investment managers to retain absolute discretion to provide certain mystery investors with greater information and the managers are not required to disclose such arrangements to TSERS.

As a result, TSERS is at risk that other unknown investors are profiting at its expense — stealing from the pension.

The above outrageous nondisclosure policies alone, as detailed in the alternative fund offering documents, render these investments inherently impermissible for a public pension, such as TSERS.

Worse still, the Treasurer refuses to provide to stakeholders offering documents that reveal that such outrageous, unfair and potentially illegal disclosure schemes are common with respect to TSERS alternative investments.

The identity of any mystery investors that may be permitted by managers to profit at TSERS' expense, as well as any relationships between these investors, the Treasurer or other public officials, should be investigated fully by law enforcement and securities regulators. Again, the absolute discretion TSERS may have granted to certain managers amounts to a license to steal from the state pension.

5. **Lack of Information Regarding Portfolio Investments**

The offering documents frequently provide that funds will invest in portfolio companies which will not be identified to the investors prior to their investment in the fund. As a result, the investors will not have any

opportunity to evaluate for themselves information regarding the investments in which the funds will invest.

As stated in the Chapter IV Investors Special Situations Fund, L.P. Confidential Offering Memorandum, July, 2006, “The Fund has not identified the particular investments it will make. Accordingly, the Limited Partners must rely upon the ability of the Investment Manager in making investments consistent with the Fund’s investment objectives and policies. The Limited Partners will not have the opportunity to evaluate personally the relevant economic, financial and other information that will be utilized by the Investment Manager in its selection of investments.”

Since pension fiduciaries are required to know, as well as evaluate the assets in which they invest, in our opinion, such provisions render these investments unsuitable for fiduciary accounts.

6. Heightened Offshore Regulation and Custody Risks

Alternative investment funds that are incorporated and regulated under the laws of foreign countries present additional, unique risks which pension fiduciaries must consider.

For example, recently three Louisiana public pensions which invested $100 million in a troubled fund managed by Fletcher Asset Management, have struggled in Cayman Islands courts to have the fund liquidated and recoup their investment. A Louisiana state legislative auditor criticized the investment practices of the three funds. The report found, among other issues, that the funds didn't adequately document whether they would be able to liquidate each investment in their portfolio at a fair market price and within a reasonable time frame.

Further, since TSERS' alternative investment assets are held at different custodians located around the world, as opposed to being held by TSERS's master custodian, the custodial risks are heightened and should be considered and disclosed to the public.

There is no evidence the Treasurer, or the State Auditor, is aware of, or has ever considered, the unique risks related to foreign regulation and custody of alternative funds.

7. Wide Latitude Regarding High-Risk Investment Strategies: Predatory Lending and Life Settlement Policies

TSERS alternative funds generally disclose a litany of specific risks related to investment strategies they may pursue such as short-selling; investing in restricted or illiquid securities as to which valuation uncertainties may exist; unlimited leverage, as well as margin borrowing; options; derivatives; distressed and defaulted securities and structured finance securities.

Further, TSERS managers may engage in controversial investment practices, such as investing in loans that may violate the anti-predatory lending laws of "some states" and life settlement policies which give rise to lawsuits alleging fraud, misrepresentation and misconduct in connection with the origination of the loan or policy.[85]

To make matters worse, the managers have retained wide latitude to invest or trade the fund's assets, and to pursue virtually any particular strategy or tactic deemed advisable by the manager — all without obtaining TSERS approval.

[85] See Fortress Credit Opportunities Funds III, Confidential Offering Memorandum, June 2011, page 60, 73.

Generally there is no specific limit on the types of positions the hedge fund may take, the concentration of its investments (by country, sector, industry, capitalization, company, or asset class), or the amount of leverage it may employ, or the number or extent of its short positions. The hedge funds may, from time to time, hold all or a portion of its assets in cash or cash equivalents when opportunities are limited or in other circumstances deemed appropriate by the manager.

8. Alternative Funds Provide No Assurance of Diversification

Since many alternative investment managers may invest a substantial portion of a fund's capital in a single investment and substantially or even completely change their investment strategies at any time, there is no way TSERS can ensure that the alternative funds provide any meaningful portfolio diversification. Generally each alternative fund manager has latitude to invest in the same assets, pursuing identical shifting strategies, as other TSERS managers, including traditional managers.

For example, the private equity managers could invest in a single asset class, say cash, or a single stock, say Enron, at an inopportune time.

Indeed, TSERS may not even know the particular investments the fund will make or the funds' current portfolio holdings.[86]

Thus, representations by the Treasurer that the decision to invest a significant portion of TSERS' portfolio in alternative funds can be justified from a diversification perspective is, at best, based upon a lack of knowledge about alternative fund operations.

[86] See reference to the Chapter IV Investors Special Situations Fund, L.P. Confidential Offering Memorandum, July, 2006 below.

9. Unlimited Use of Leverage

The offering documents generally provide that the alternative funds and the portfolio companies in which they invest may use significant, even unlimited leverage. This use of leverage can exacerbate losses and increase volatility. The manager has discretion regarding the amount of leverage used, including the use of derivatives and margin trading. Any leveraging strategies the manager employs increase the Fund's transaction costs, interest expenses, and other costs and expenses.[87]

10. Absence of Regulatory Oversight

Unlike traditional investments, the alternative funds in which TSERS may invest may be managed by investment advisers not registered with the SEC under the Investment Advisers Act of 1940. Further, the funds themselves are not registered as "investment companies" under the Investment Company Act of 1940.[88] As a result, the limited partners lack many meaningful protections of those statutes.

11. Bogus Private Equity Fees

A majority of private-equity firms inflate fees and expenses charged to companies in which they hold stakes, according to a recent internal review by the SEC, raising the prospect of a wave of sanctions against managers (including TSERS's hundreds of private equity managers), by the agency.

[87] See Fortress Credit Opportunities Funds III, Confidential Offering Memorandum, June 2011, page 47.

[88] Chapter IV Investors Special Situations Fund, L.P. Confidential Offering Memorandum, July, 2006.

More than half of about 400 private-equity firms that SEC staff examined charged unjustified fees and expenses without notifying investors.

"The private-equity model lends itself to potential abuse because it's so opaque, according to Daniel Greenwood, a law professor at Hofstra University in New York and author of a 2008 paper entitled "Looting: The Puzzle of Private Equity." The attraction of the funds is that the managers have broad discretion, which also means that investors have a hard time knowing what the managers are doing, he said."

According to another expert cited in the article, "The industry is going to be forced into change because, frankly, when your big investors are *public plans and other money that's run by fiduciaries* (emphasis added), you can't afford as a business matter to be deemed to be engaging in fraud. Fraud doesn't sell very well."[89]

While we requested documents related to such potential violations of the securities laws from the Treasurer, our request was denied.

Accordingly, in our opinion, whether any of the TSERS private equity funds have been charging bogus fees to portfolio companies in violation of the federal securities laws is a matter which should be referred to the SEC for further investigation, as well as potential recovery to TSERS of its share of any fees improperly charged.

12. Private Equity Transaction Fees Securities Law Violations

Transactions fees charged by private equity funds, sometimes called the "crack cocaine of the private equity industry" because the fees are not traditionally subject to minimum performance requirements, are increasingly opposed by public pensions and have recently been the

[89] Bogus Private-Equity Fees Said Found at 200 Firms by SEC, Bloomberg News, April 7, 2014.

subject of an SEC whistleblower complaint filed by a senior private equity insider.[90]

The SEC whistleblower credibly alleges that private equity firms have been violating securities laws by charging transaction fees without first registering as broker-dealers with the SEC. If the private equity firms hired by TSERS have been violating the state and federal securities laws, they may be required by the states and the SEC to refund to investors the transaction fees wrongfully charged.

While we requested information regarding such potential violations of the securities laws from the Treasurer, our request was denied.

Accordingly, in our opinion, whether any of the TSERS private equity funds have been charging transactions fees in violation of the state and federal securities laws is a matter that should be referred to the North Carolina Securities Division and the SEC for further investigation, as well as potential recovery to TSERS of its share of any transaction fees improperly charged.

13. Private Equity Monitoring Fees Tax Law Violations

With respect to private equity so-called monitoring fees paid by private equity owned portfolio companies, whistleblower claims have been filed with the Internal Revenue Service alleging that these fees are being improperly characterized as tax-deductible business expenses (as opposed to dividends, which are not deductible), costing the federal government hundreds of millions of dollars annually in missed tax revenue.[91]

[90] A whistleblower wants to take away private equity's 'crack cocaine,' CNBC, December 5, 2013.

[91] Tax Expert Sees Abuse in a Stream of Private Equity Fees, New York Times Deal Book, February 3, 2014.

According to the Wall Street Journal, Gregg Polsky, a tax-law professor at the University of North Carolina, examined 229 large buyout deals in which information on monitoring fees is available and tallied more than $3.9 billion in monitoring-fee payments from 2008 to 2012 that have features suggesting they were dividend-type payments.[92]

While we requested information regarding such monitoring fees from the Treasurer, our request was denied.

Based upon our preliminary research it appears that at least three monitoring agreements involving *a single* TSERS private equity fund may be suspect to re-characterization by the IRS.[93]

Given the hundreds of TSERS private equity fund investments and hundreds of suspect monitoring fees identified by Mr. Polsky, it seems highly likely that additional violations of tax law exist with respect to TSERS private equity investments.

Accordingly, in our opinion, whether any of the portfolio companies owned by TSERS private equity funds have been improperly characterizing monitoring fees as business expenses in violation of the Internal Revenue Code and costing the federal government hundreds of millions annually in tax revenue is a matter that should be referred to the IRS for further investigation.

14. Private Equity Management Fee Waivers Tax Law Violations

---

[92] Private-Equity Firms' Fees Get a Closer Look, Wall Street Journal, February 2, 2014.

[93] The Untold Story of *Sun Capital*: Disguised Dividends, Gregg Polsky, Tax Notes, February 3, 2014.

The IRS has in recent years been examining the propriety of private equity management fees waivers, which have allowed many fund executives to reduce their taxes by converting ordinary fee income into capital gains taxed at substantially lower rates, costing the federal government billions of dollars annually in missed tax revenue.[94]

As stated in connection with an investigation into such waivers at the Los Angeles County Employees' Retirement Association (and a request for information that was denied by the fund):

"investment limited partnership agreements frequently are used to implement 'management fee waivers' that leading tax experts view as illegal, essentially a fraud upon the U.S. Treasury. This is one of the main reasons why giving out limited partnerships agreements 'risks alienating alternative fund managers,' to use LACERA's own words, since it would be tantamount to blowing the whistle on their tax fraud. Instead of acting as the whistleblower, LACERA has made the decision to assist with the cover-up."[95]

While we requested information regarding potential violations of tax law related to these waivers from the Treasurer, our request was denied.

Accordingly, in our opinion, whether any of the TSERS private equity funds have been complicit in allowing their managers to improperly convert ordinary fee income into capital gains, costing the federal government billions of dollars annually in missed tax revenue, is yet another matter that should be referred to the IRS for further investigation.

[94] IRS Wakes Up to Private Equity Scam, Naked Capitalism, October 16, 2013.

[95] Los Angeles Public Pension Fund Tells Us It Is a Happy, Trusting Victim of Private Equity Funds, Naked Capitalism, March 28, 2014.

XIII. Treasurer Conceals Investment Fees Will Skyrocket to $1 Billion

A. Fiduciary Duty To Ensure Investment Fees Are Reasonable

Unlike most other industries, the fees money managers charge institutional and retail investors for comparable investment services vary astronomically.

Passive, or index investment management services, can be purchased by institutional investors for 1 basis point (one one-hundredth of a percent) or even "for free."[96] Active managers, who attempt to beat the market by stock-picking, may charge pensions fees that are 120 times greater (1.2 percent). Alternative investment managers, including hedge, venture and private equity, may charge asset-based, performance and other multiple layers of fees amounting to approximately 8 percent—800 times greater fees than indexing.

Paying higher fees for active traditional or alternative asset management does not guarantee and, in fact, negatively correlates to superior investment performance. Indeed, the overwhelming majority of active managers fail to outperform market indexes over time net of fees; the higher the fees, the greater the drag on investment returns.

A recent report by the Maryland Public Policy Institute and the Maryland Tax Education Foundation which examined the investment fees and investment performance of state pension funds concluded:

"State pension funds, including Maryland, have succumbed for years to a popular Wall Street sales pitch: "active money management beats the market." As a result, almost all state pension funds use outside managers to select, buy and sell

---

[96] Certain index managers will manage large accounts at no cost, in exchange for securities lending income related to the portfolio.

investments for the pension funds for a fee. The actual result — a typical Wall Street manager underperforms relative to passive indexing — is costly to both taxpayers and public sector employees.

For example, **the top ten states — in terms of Wall Street fees — had a lower pension fund investment performance — over the last five fiscal years — than the bottom ten states** (emphasis added)... State pension funds should consider indexing. Indexing fees cost a state pension fund about 3 basis points yearly on invested capital vs. 39 basis points for active management fees (or 92% less)… By indexing most of their portfolios, we conclude the 46 state funds surveyed could save $6 billion in fees annually, while obtaining similar (or better) returns to those of active managers."[97]

It is well established that sponsors of public and private retirement plans have a fiduciary duty to ensure that the fees their plans pay money managers for investment advisory services are reasonable. Fees paid for such retirement plan investment services have always been an important consideration for ERISA retirement plan fiduciaries. Further, in recent years such fees have come under increased scrutiny because of class action litigation, Department of Labor regulations, and congressional hearings.[98]

According to the Department of Labor:

"Plan fees and expenses are important considerations for all types of retirement plans. As a plan fiduciary, you have an obligation under ERISA to prudently select and monitor plan investments, investment options made available to the plan's participants and beneficiaries, and the persons providing services to your plan. Understanding and evaluating plan fees and expenses associated with plan investments, investment options, and services are an important part of a fiduciary's responsibility. This responsibility is ongoing. After careful evaluation during the

---

[97] Wall Street Fees, Investment Returns, Maryland and 49 Other State Pension Funds by Jeff Hooke and John J. Walters, July 2, 2013. The authors reviewed the Wall Street money management fees of all 50 states and the states five-year annualized investment returns. The information was disclosed in the state pension funds' CAFR.

[98] Revealing Excessive 401(k) Fees, The New York Times, June 3, 2011.

initial selection, you will want to monitor plan fees and expenses to determine whether they continue to be reasonable in light of the services provided."

State and local government pensions are exempt from ERISA and are governed by state law. However, because ERISA and state law protections both stem from common law fiduciary and trust principles, best practices for public pensions are frequently similar to those found in ERISA.

At the outset, sponsors of public, as well as private retirement plans must take steps to understand the sources, amounts, and nature of the fees paid by the plan, as well as the related services performed for such fees. After all, a plan sponsor cannot determine the reasonableness of fees paid without a comprehensive understanding of the plan's services and fees.

Whether a plan's fees are reasonable depends upon the facts and circumstances relevant to that plan. The plan sponsor must obtain and consider the relevant information and then make a determination supported by that information.

B. Treasurer's Statutory Duty to Disclose All Direct and Indirect Investment and Placement Fees

As mentioned earlier, effective August 2013, a new state law requires the Treasurer to disclose all direct and indirect investment management and placement agent fees in her quarterly Gov Ops reports. The Treasurer has failed to supplement the Gov Ops reports with the newly required information. As a result of the Treasurer's failure to comply with applicable law, SEANC requested the fee information that has been withheld from the public, as well as certain other information detailed below.

C. SEANC Requests Disclosure of TSERS Total Investment Management Fees and Expenses

In a letter dated January 8, 2013, SEANC requested that the Treasurer provide disclosure of the total annual fees applicable to each of TSERS's investments since January 1, 2003, including any fund-of-fund and manager-of-manager multiple layers of fees; asset-based fees; operating fees and expenses; and performance fees by manager or fund, and disclosing each of the components of the applicable fees and expenses separately.

In response, the Treasurer provided incomplete, misleading information regarding management fees and incentive fees only related to the period from June 30, 2006 through June 30, 2013.[99] The Treasurer declined to provide information regarding substantial fund-of-fund and manager-of-manager multiple layers of fees, as well as substantial operating fees and expenses (as discussed below) we specifically requested.

Worse still, the Treasurer's incomplete disclosure of fees is grossly misleading to the public in three respects.

- First, as explained further below, the Treasurer has withheld from public disclosure a massive portion of the fees and expenses related to alternative assets which results in effectively understating the fees, expenses and risks related to these investments, as well as TSERS as a whole.[100]

---

[99] For the years 2006 through 2008, the total fees paid by TSERS in dollars and as a percent of assets under management were not provided.

[100] While EnnisKnupp says a 2012 CEM Benchmarking report indicates that TSERS is below median in total cost relative to assets under management compared to similar sized public pension plan peers, the CEM comparison data is deeply flawed, in our opinion, in that it analyzes only fees input by public plan sponsors. As revealed in this report, the Treasurer is not disclosing a massive portion of TSERS

- Second, the fact that the explosion in total plan fees is due to the Treasurer's growing use of alternative investments has been obscured by (a) withholding information regarding investment performance and total fees paid to individual managers from public reports; and (b) including low-cost (global equity) and virtually no-cost (internally managed fixed income) assets amounting to approximately $65 billion in the calculation of fees as a percent of total plan assets.
- Third, the information the Treasurer has withheld is clearly material to an assessment by stakeholders of the escalating costs of the plan, as well as the relative merits of the secretive, high-cost, high-risk, illiquid alternative investments versus low-cost, lower risk, transparent, liquid traditional investments.

In a letter dated February 27, 2014, we notified the Treasurer that based upon our preliminary review of the limited information provided to date in response to SEANC's public records request, it was apparent that the Treasurer had failed to disclose a significant portion of the hedge fund and alternative investment manager fees paid by TSERS to money managers. Indeed, it appeared that the massive hidden fees she failed to disclose in many instances dwarfed the excessive fees disclosed to us.

D. Disclosed Wall Street Investment Fees Have Skyrocketed and Will Continue to Steeply Climb

The limited investment fee information provided by the Treasurer indicates that disclosed fees have skyrocketed more than 1,000 percent since 2000 and have almost doubled since FY 2008/2009 from $217 million to $416 million. In the past fiscal year alone, disclosed fees have

investment management fees and expenses. Investment Fiduciary Governance Commission Briefing Book, January 23, 2014.

climbed from $295 million to $416 million — a staggering increase of over 40 percent.[101]

Worse still, according to the Treasurer, annual investment fees are projected to increase about 10 basis points — another almost $90 million — due to the allocation away from low-cost internally managed fixed income to high-cost, high-risk alternative funds.[102]

In summary, the total investment fees disclosed by the Treasurer are projected to steeply climb to over **$500 million**.

E. Undisclosed Fees Are Massive

Unlike traditional investments, such as stocks, bonds and mutual funds, alternative investments are opaque and subject to myriad hefty fees.

Based upon a limited review of only the undisclosed fees related to numerous readily-identifiable funds of funds owned by TSERS, as detailed below, we have estimated undisclosed fund of fund fees of $155 million annually and cumulative undisclosed fund of fund fees of $880 million.

In our opinion, it is highly likely that a comprehensive review of all applicable investment fees and expenses would reveal total undisclosed fees at this time of approximately $400 million.[103]Further, based upon the Treasurer's projected fee increase above, we estimate undisclosed fees will also increase comparably, $90 million.

[101] As mentioned earlier, the CAFR, Gov Ops and Treasurer's most recent disclosure of FY 2013 fees differ materially.

[102] IMD Performance Review, February 19, 2014.

[103] Based upon our preliminary research, the myriad hidden fees related to TSERS's $6.5 billion real estate portfolio are substantial in excess of $200 million.

Thus, we estimate total TSERS annual fees and expenses will increase to approximately **$1 billion** — almost twice the disclosed amount projected by the Treasurer.

The increase of disclosed fees in 2013 to $416 million, while staggering, is a gross and intentional understatement by the Treasurer, in support of her failed alternative investment strategy. In our opinion, if the magnitude of the formidable undisclosed fees related to TSERS alternative investments were acknowledged, public acceptance of the Treasurer's high-risk, underperforming investment gamble would wane.

F. Hidden Fund of Fund Fees to Wall Street Exposed

Below are a few examples of the significant fund of fund fees, undisclosed by Cowell, that we discovered related to specific asset categories established by the Treasurer in the most recent FY 2012/2013 data provided to us.[104]

This is not, by any means, an exhaustive accounting of the hidden fees and expenses related to even all the fund of funds owned by TSERS. Again, the overwhelming majority of the information we requested regarding fees and expenses was not provided. Further, TSERS reports do not generally disclose which investments are funds of funds.

Cowell's failure to disclose fund of fund fees is especially troubling given that in a 2010 EnnisKnupp report, the firm had warned the Treasurer, "While funds of hedge funds are highly diversified investments, the investor is required to pay fees to both the underlying hedge fund manager and the fund-of-funds manager. This additional layer of fees is likely to exceed 1% per year, or approximately $6 million." EnnisKnupp

[104] It is noteworthy that in response to our published findings regarding hidden fund of fund fees at TSERS, the Treasurer in her 2013 Annual Report added new disclosure admitting that fund of fund fees are not included in the fees stated.

went on to recommend 'tracking the "second layer' of fees within the hedge fund program would be beneficial."[105]

Further, in a report to an Investment Fiduciary Governance Commission created by the Treasurer dated shortly after our request, EnnissKnupp had opined, "There is evidence of potential cost-inefficiencies in the use of certain types of fund-of-funds and real estate commingled funds."Also, "We prefer direct investments with multi-strategy managers versus investments in fund-of-funds because using the latter could result in over-diversification, additional layering of fees, and the inability to re-allocate in rapidly changing market environments." [106]

In other words, the Treasurer is fully aware of the multiple layers of fees related to fund of funds and that the fees are excessive, as well as avoidable, however she has intentionally withheld this information known by her from the public. Further, Cowell has hidden these fees related to fund of funds for the past four years despite having had them called to her attention by EnnisKnupp in 2010 and again recently.

Hedge, private equity, credit strategies and inflation protection fund of funds, all of which TSERS invests in, are highly problematic for numerous reasons including, multiple layers and excessive amounts of fees; questionable manager of managers due diligence and monitoring; extensive duplication of underlying managers where multiple fund of funds are involved; and rampant conflicts of interest. Finally, the complexity and lack of transparency related to the TSERS multiple fund of funds approach, involving hundreds of underlying alternative

[105] EnnisKnupp Independent Review and Evaluation of the North Carolina Retirement Systems, April 19, 2010, page 102.

[106] Investment Fiduciary Governance Commission Briefing Book, January 23, 2014.

managers precludes compliance with applicable fiduciary standards for the reasons stated below.

Benchmark investigations have revealed that total fees and expenses related to fund of funds often exceed 5 percent.[107]

In contrast to the average 25 basis point investment advisory fee TSERS pays its superior-performing traditional Global Equity managers, this is a staggering — 20 times greater — amount. Further, it is unclear why two layers of asset-based fees and expenses are necessary. Is it necessary to pay an asset-based fee to a firm that doesn't actually manage any assets? Do fund of funds managers really provide superior manager selection? If so, how many fund of funds are necessary to achieve the optimal level of diversification? If not, a direct investment approach would be preferable as it would eliminate an additional layer of fees.

While the fund of funds approach permits diversification into a greater number of funds than the direct approach, multiple fund of funds involves unnecessary diversification — a fact acknowledged by Hewitt EnnisKnupp. It is impossible for any single manager to significantly add value and it seems likely the vast number of managers will result in, at best, a market rate of return net of the myriad fees, with significantly greater investment and operational risk.

Further, research has shown that on average, fund on funds managers fail to deliver additional return. The reason that hedge fund of funds have not fared well, according to a report entitled "Hedge Funds: Too Much of a Good Thing" in Bernstein Wealth Management Research, June 2006, is their multiple fee structure. Fund of funds managers need

---

[107] According to a recent CEM Benchmarking Investment Performance and Costs report, real estate and private equity fund of fund median cost, not including the 20 percent incentive fee, amount to approximately 105 and 244 basis points respectively.

to pick not just better-than-average funds to produce incremental return, but among the best, concludes Bernstein, to justify the outlandish 5 percent fees they charge.

A December 18, 2006, Bloomberg News article entitled "Dirty Wall Street Secret: Hedge Funds of Funds Pay T-Bill Rates," also questions the investment merits of hedge fund of funds.

1. Hedge Funds

The six hedge funds listed in this category in the most recent FY 2012/2013 data provided to us by the Treasurer are hedge funds of funds. As noted in the Wall Street Journal, "funds of hedge funds come with heaps of fees."[108] While each of the six hedge funds of funds utilize on average 20 to 30 underlying managers (who are generally paid greater fees than oversight fund of funds managers), the greater fees paid to the approximately 150 underlying managers — information SEANC specifically requested — have not been disclosed by the Treasurer.

According to a recent report by Hewitt EnnisKnupp, since 92 percent of the hedge fund portfolio is invested with a single manager, Franklin Street Partners, which is a fund of funds, Hewitt EnnisKnupp believes the allocation should be more diversified to include additional direct investments with hedge fund managers, in part to eliminate the over-diversification and additional layer of fees related to the fund of funds.

Based upon Franklin Partners offering material we have reviewed, it appears that TSERS currently is, and has always been, either the sole or primary investor in the Franklin fund of funds.

[108] Funds of Hedge Funds Come With Heaps of Fees, December 4, 2013.

The myriad fees related to hedge fund of funds that we requested (and the Treasurer has not disclosed) are substantial.

For example, the fee information provided indicates that with respect to Franklin Street Advisers in 2012-2013, the pension paid $1.8 million in asset-based fees and $800,000 in incentive fees, or a total of approximately $2.6 million for managing an estimated $260 million. This amounts to an apparent 75 basis point asset-based fee and a 5 percent incentive fee.[109]

Since Franklin Street is a fund of funds, the underlying hedge fund managers are paid an asset-based fee and an incentive fee, which in the industry are generally 2 percent and 20 percent, respectively.

It appears that the undisclosed underlying investment advisory fees related to the Franklin investment alone — just one of the hundreds of funds in which state pension has invested — may amount to $5.2 million in asset-based fees and $3.2 million in incentive fees or a total $8.4 million in 2013.

However, based upon a review of relevant SEC filings, it appears that there may be additional significant trading fees paid to Franklin that are not disclosed. Hedge fund trading costs are conservatively estimated to amount to approximately 2 percent annually.

While Franklin Street's website indicates that the firm does not deal in any securities and maintains an arm's length relationship with all external managers on its platform, according to SEC filings, Franklin

---

[109] To date the Treasurer has failed to provide the investment advisory contracts specifically requested by SEANC which recite, in part, the fees money managers charge the pension.

Street Securities, Inc., an affiliate of the firm, is a FINRA registered broker/dealer utilized to execute trades for many accounts.[110]

The broker-dealer firm, which does not actually execute trades itself but serves as a middleman, earns as compensation the difference between the fee it pays to its correspondent clearing broker for execution and the commission it charges clients. The trading commissions clients pay to Franklin's affiliated brokerage are significantly higher than the best rates available today.

Assuming that Franklin's affiliated brokerage executes all of the trades related to the TSERS account, the commissions paid to the affiliate may amount to $5.2 million.

To be clear, brokerage compensation, if any, paid to the Franklin affiliate, which may be substantial (given high portfolio turnover generally related to hedge funds) is in addition to the asset-based and incentive fees paid to Franklin for selecting and monitoring external managers and the fees paid to the underlying hedge fund managers.

Finally, the Treasurer has failed to provide the information specifically requested by SEANC regarding the substantial multiple layers of operating fees and expenses related to the hedge fund of funds.

Hedge fund of funds also pay organizational, offering and operating costs and expenses, including legal, administrative and audit, as well as the costs and expenses related to the underlying hedge funds in which

[110] Franklin Street's Form ADV Part II states, "Clients authorize Franklin Street Advisors, Inc., among other things, to select brokers for execution of transactions, including an affiliated broker dealer, Franklin Street Securities, Inc. (FSS). FSA uses Franklin Street Securities to execute trades for many accounts. When FSS executes trades, client commission charges vary from $.03 to $.06 a share with a minimum of $25.00 per trade. Pershing LLC is the clearing broker for FSS and charges between $16 a trade up to $.02 a share depending on execution. FSS is rebated the difference between the execution fee and the commission charged to the client.

they invest. Industry insiders estimate such multiple layers of costs and expenses amount to approximately 1.5 percent or approximately $3.9 million in connection with the Franklin investment. Certain of these expenses may be disclosed in the annual report of the funds of funds.

In summary, total asset management, brokerage, operating fees and expenses related to the Franklin investment may amount to approximately $20.1 million annually, an amount almost ten times greater than the $2.6 million in fees disclosed by the Treasurer.

Since TSERS invested $335 million in the Franklin hedge fund of funds in 2002 and has remained invested since then,[111] total undisclosed fees related to this single manager could amount to well in excess of $200 million.

With respect to the other five hedge fund managers, incentive fees amounting to tens of millions over time[112] paid to the oversight managers are not disclosed; further, no asset-based or incentive fees paid to the underlying managers, trading, or operating costs and expenses, are disclosed.

Finally, as we noted in a letter to the Treasurer dated February 27, 2014, while Franklin Street and the other hedge fund of funds managers were listed in the 2011 Annual Report, they disappeared, without explanation, from the list of managers in the most recent 2012 annual report produced by her office — even though these managers continue to manage TSERS assets and are paid handsomely to do so.

---

[111] TSERS assets at Franklin amounted to in excess of $400 million in 2006.

[112] For example, according to the Treasurer's response to an SEC Letter of Inquiry dated May 8, 2009, incentive fees paid to the CARS LLP (aka Quellos) fund in 2006-2007 alone amounted to approximately $9 million.

As noted earlier and indicated in the 2010-2011 Annual Report, the long-term investment performance of the Hedge Strategies Investment Portfolio was horrendous — 1.6 percent versus 6 percent for the custom benchmark.

2. **Credit Strategies**

Fees related to 22 TSERS investments categorized as Credit Strategies are, by far, the most outlandish.

According to the Treasurer, with respect to $3.3 billion or approximately 4 percent of its portfolio invested in Credit Strategies, TSERS paid Wall Street money managers over $116 million in fees in 2013 — an amount well in excess of the fees TSERS paid for both global equity and internal fixed income management of over $65 billion, or 80 percent of its portfolio.

Worse still, the Treasurer has grossly understated the lavish fees paid by TSERS to the Credit Strategies managers.

For example, with respect to a $500 million investment in the PAAMCO-Newport Burgundy hedge fund of funds, the Treasurer has disclosed only a $5.2 million fee paid in 2013.

While the PAAMCO hedge fund of funds apparently charges a 1 percent asset-based fee and no incentive fee, the underlying hedge fund managers charge asset-based and incentive fees and such fees generally amount to 2 percent and 20 percent respective. Thus, we estimate the undisclosed asset-based fees paid the underlying managers amount to approximately $10 million in 2013. The undisclosed incentive fees paid

the underlying managers in 2013, we estimate to amount to approximately $16.5 million.[113]

Assuming trading costs of 2 percent and multiple layers of operating fees and expenses of 1.5 percent, we estimate these hidden fees amount to $17.5 million.

In summary, total asset management, brokerage, operating fees and expenses related to the PAAMCO investment may amount to approximately $49 million annually, an amount almost 10 times greater than the $5.2 million in fees disclosed by the Treasurer.

Since TSERS has been invested in the PAAMCO hedge fund of funds since 2010, total undisclosed fees related to this single manager could amount to in excess of $200 million.

With respect to a $75 million investment in Fortress Credit Opportunities III, the Treasurer has disclosed only a $210,000 management fee paid in 2013 and no incentive fee.

According to the relevant private offering memorandum, Fortress charges a 1.5 percent asset-based fee and 20 percent incentive fee. Thus, it appears the Treasurer may not have even disclosed the entire asset-based fees related to this investment.

Worse still, it is stated in the offering documents that “Service companies and managers of pooled investments (“Other Investment Fund Managers”) in which the funds invest may receive compensation based upon the performance of the assets they service or in which such pooled investment vehicles invest … the existence of such incentive fees

---

[113] This estimate is based upon an assumed 16.5 percent performance by PAAMCO, i.e., performance in line with the other Credit Strategies managers, and a 20 percent performance fee paid to the underlying manager.

and other fees … result in the funds paying fees twice, once to the General Partner and once to the Service Company or Other Investment Manager to service or manage the same assets …"[114] Thus, assuming the underlying managers charge asset-based and incentive fees and such fees generally amount to 2 percent and 20 percent respective, we estimate the undisclosed asset-based fees paid to the underlying managers, amount to approximately $1.5 million in 2013. The undisclosed incentive fees paid to the underlying managers in 2013, we estimate to amount to approximately $2.4 million.[115]

Assuming trading costs of 2 percent and multiple layers of operating fees and expenses of 1.5 percent, we estimate these hidden fees amount to $2.6 million.

In summary, total asset management, brokerage, operating fees and expenses related to the Fortress investment may amount to approximately $6.5 million annually, an amount 30 times greater than the $210,000 in fees disclosed by the Treasurer.

3. Inflation Protection

TSERS has invested $2.3 billion in 29 Inflation Protection funds with disclosed fees in excess of $25 million. Again, the Treasurer has failed to disclose significant fees related to these investments.

For example, with respect to the Blackstone Resources Select Fund, a commodities fund of funds in which TSERS has invested $500 million,

[114] See Fortress Credit Opportunities Funds III, Confidential Offering Memorandum, June 2011, page 41.

[115] This estimate is based upon an assumed 16.5 percent performance by PAAMCO, i.e., performance in-line with the other Credit Strategies managers, and a 20 percent performance fee paid to the underlying manager.

the Treasurer has disclosed $3.6 million in asset-based fees and no incentive fees.

It appears that the management fee charged at the fund of funds level amounts to 0.72 percent of assets. There is no performance fee at the fund of funds level. Initial research indicates that the management fees for the underlying managers, which the Treasurer has not disclosed, average 0.75 percent with an incentive fee of 20 percent.[116]

Thus, the undisclosed asset-based fees to the underlying managers alone, i.e., $3.75 million, exceed the total fee the Treasurer has disclosed with respect to this investment. Since it is unclear, based upon the limited performance information we have been provided, whether the investment performance of the Blackstone fund underlying managers resulted in any incentive-based fees, we have omitted any estimate of undisclosed performance fees.

Assuming trading costs of 2 percent and multiple layers of operating fees and expenses of 1.5 percent, we estimate these hidden fees related to the Blackstone fund of funds amount to $17.5 million annually.

In summary, total asset management (assuming no performance fees whatsoever), brokerage, operating fees and expenses related to the Blackstone Resources investment may amount to approximately $25 million annually—an amount seven times greater than the $3.6 million in fees disclosed by the Treasurer.

Since TSERS has been invested in the Blackstone commodities fund of funds since 2010, total undisclosed fees related to this single manager

116 http://www.nj.gov/treasury/doinvest/pdf/AlternativeInvestments/RealAsset/BlackstoneResourcesSelectFund.pdf

could amount to in excess of $100 million—assuming no performance fees over the past four years whatsoever.

4. Real Estate

TSERS has invested $6.5 billion in 96 real estate funds with total disclosed fees of approximately $90 million. Approximately $11 million of these disclosed fees are incentive fees that have been paid to individual managers despite the horrendous performance of the real estate portfolio overall. Again, the Treasurer has failed to disclose significant fees.

As mentioned earlier, in a report to the Investment Fiduciary Governance Commission created by the Treasurer dated shortly after our request for information, EnnissKnupp opined, "There is evidence of potential cost-inefficiencies in the use of certain types of… real estate commingled funds."[117] Fund of funds are an example of only one type of cost-inefficiency.

With respect to a $50 million investment in the American Value Partners Fund I real estate fund of funds, the Treasurer has disclosed only a $163,780 fee paid in 2013.

Assuming the underlying real estate managers charge asset-based and incentive fees of 2 percent and 20 percent respectively, we estimate the undisclosed asset-based fees paid to the underlying managers, amount to approximately $1 million in 2013.

However, with respect to real estate asset management specifically, there many additional transaction, development management and property management fees that may be charged in addition to the basic annual management fee — fees that the Treasurer has not disclosed.

[117] Investment Fiduciary Governance Commission Briefing Book, January 23, 2014.

These undisclosed fees may be formidable and amount to 3 percent, or $195 million, with respect to TSERS' assets.

As a result, in our opinion, real estate hidden fees should be the subject of a separate investigation.

Over a trailing five-year period, the TSERS Real Estate portfolio has massively underperformed its primary benchmark by 4.3 percent per year, according to Hewitt EnnisKnupp.[118]

According to research by Cliffwater LLC, a pension consultant, for the 10 years ending June 30, 2011, for 23 reporting pensions, TSERS ranked 21, hugely underperforming the State Fund Real Estate Average of 6.7 percent by 4 percent.[119]

5. Private Equity

TSERS has invested $3.5 billion in approximately 100 Private Equity funds, paying disclosed fees of approximately $76 million in 2013. Approximately $28 million of these disclosed fees are incentive fees that have been paid despite the horrendous performance of the private equity portfolio overall noted below.

According to a recent report by Hewitt EnnisKnupp, 28 percent of the TSERS Private Equity assets, or almost $1 billion, is invested in multiple fund of funds "which are often not utilized by larger investors due to the relatively higher fees." Says the firm, "Due to the size of the NCRS private equity portfolio, we believe the use of fund-of-funds should be reduced."[120]

---

[118] Id.

[119] Trends in State Pension Asset Allocation and Performance, Cliffwater LLC, June 26, 2012.

[120] Investment Fiduciary Governance Commission Briefing Book, January 23, 2013.

Again, the Treasurer has not disclosed the substantial layers of fees and expenses related to the private equity fund of funds investments.

For example, four StepStone funds in which TSERS has invested a total of approximately $500 million are private equity fund of funds. Since each private equity fund of funds invests in approximately 20 to 25 underlying funds, TSERS has indirectly invested in 90 private equity funds through the StepStone funds alone, in addition to the approximately 100 direct private equity investments disclosed by the Treasurer.

Given the substantial number of direct private equity investments, it is highly likely, based upon our experience that StepStone and the other funds of funds have indirectly invested in some of the very same funds in which TSERS has directly invested. If true, TSERS is paying an additional layer of fees to StepStone and the other funds of funds managers with respect to those direct investments for no apparent reason.

Treasurer Cowell has disclosed approximately $2.3 million in asset-based fees paid to the StepStone funds, at an overall effective rate of 46 basis points, and no incentive fees. As disclosed by StepStone, "underlying private equity funds will impose their own fees and expenses and an investor in Fund of Private Equity Funds will pay two levels of fees and expenses."[121]

Based upon industry standards, we estimate the undisclosed asset-based fees of 2 percent paid to underlying managers related to the StepStone funds amount to approximately $10 million in 2013. The

---

[121] StepStone Group LP Form ADV, Part II, page 7.

amount of any performance fees paid to the underlying managers, if any, is undisclosed and given the dismal long-term performance of TSERS private equity assets, we have declined to project any such incentive fees.

According to StepStone, investors in a fund of private equity funds may incur other expenses, depending on the nature of the investment vehicle. For example, expenses may be assessed either at the fund or portfolio company level that include structuring, topping, breakup, monitoring, directors', organizational, set-up, closing, commitment, advisory, consulting, underwriting, investment banking, broker, and syndication expenses in connection with the purchase, monitoring or disposition of underlying investments. Expenses may also be incurred to compensate third-party service providers such as attorneys, auditors, accountants and custodians.

According to a recent survey of private equity transaction and monitoring fees,[122] transaction fees tended to converge around an average of 1.3 percent of deal size for deals under $500 million, 1.1 percent for deals between $500 million and $1 billion, and 0.8 percent for deals over $1 billion. However, more recently, transaction fees for middle-market and large-market deals have rebounded since 2009 to approximately 1.2 percent and 1 percent, respectively.

Monitoring fees averaged 2.2 percent of deal size for lower middle-market deals under $500 million, and averaged close to 1.5 percent for deals over $500 million. Similar to transaction fees however, monitoring fees have been increasing since 2009, with lower-middle market deals averaging over 2.5 percent of deal size and middle-market deals averaging close to 1.8 percent of deal size.

---

[122] Transaction and Monitoring Fees: On the Rebound? A joint investigation by Dechert and Preqin, November 2011.

The study also observed that when private equity firms charge fees for special types of transactions after acquisition (such as add-on acquisitions, debt financings, sales of equity and exit transactions), the fees tended to range from 0.8 percent to 1.4 percent of transaction size.

Since private equity transaction and monitoring fees may be allocated entirely to the general partner or otherwise divided between the other partners of the private equity fund, we assumed that half of the total transaction and monitoring fees of 4.9 percent, or 2.45 percent, were paid by TSERS. In addition, we assumed multiple layers of operating fees and expenses of 1.5 percent. Thus, we calculated these total undisclosed fees to amount to $19.7 million in 2013.

In summary, total asset management (assuming no incentive fees whatsoever), transaction, monitoring, operating fees and expenses related to the four StepStone funds may amount to approximately $32 million annually — an amount 14 times greater than the $2.3 million in fees disclosed by the Treasurer.

Since TSERS has been invested in the Parish Capital private equity funds of funds since 2004 (which were sold to StepStone in 2011), total undisclosed fees related to this single manager could amount to in excess of $300 million — assuming no performance fees whatsoever over the decade.

In another private equity fund of funds example, with respect to the $230 million invested in the Credit Suisse/NC Innovation Fund, the Treasurer disclosed fees of $1.6 million or 72 basis points. While, according to published reports, the firm will be eligible for fees based

upon the fund's performance, no incentive fees are disclosed for 2013.[123]

According to the Innovation Fund website, it currently has five "fund of funds" partners, including Carousel, Falfurrias, Frontier, River Cities and Kian Capital. The Treasurer has not disclosed any asset-based or performance fees related to the underlying managers to the Innovation Fund.

Ironically, TSERS also has invested a total of $45 million directly in two Carousel Capital private equity funds; thus, it would appear that the pension could avoid paying Credit Suisse an oversight fee of 72 basis points for an investment in a Carousel private equity fund.

Assuming the Innovation Fund underlying private equity managers charge asset-based and incentive fees and such fees generally amount to 2 percent and 20 percent respective, we estimate the undisclosed asset-based fees paid to the underlying private equity managers amount to approximately $4.6 million in 2013. Any incentive fees paid to the underlying managers are not undisclosed.

In addition to this amount, we assume transaction and monitoring fees of 2.45 percent and multiple layers of operating fees and expenses of 1.5 percent. Thus, we calculated these total undisclosed fees amount to $9 million in 2013.

In summary, total asset management fees (assuming no incentive fees whatsoever), transaction, monitoring, operating fees and expenses related to the Innovation Fund may amount to approximately $15.2 million annually — an amount almost 10 times greater than the $1.6 million in fees disclosed by the Treasurer.

[123] $230 Million Innovation Fund Will Divert Pension Money Into Tech Firms, Carolina Journal News Reports, March 16, 2010.

Since TSERS has been invested in the Innovation private equity fund of funds since 2010, total undisclosed fees related to this single manager could amount to in excess of $65 million — assuming no performance fees over the past five years whatsoever.

As mentioned above, since according to Hewitt EnnisKnupp, TSERS has approximately $980 million in private equity fund of funds, in addition to the $730 million invested in the StepStone and Innovation Fund another $250 million is invested in fund of funds the identities of which are not readily apparent. For example, TSERS has invested $550 million in three other Credit Suisse North Carolina Investment Funds some or all of which may, or may not be, funds of funds.[124]

Nevertheless, we can estimate that the total undisclosed fees related to the remaining $250 million in private equity funds of funds — asset management fees paid to the underlying managers (assuming no incentive fees); transaction, monitoring fees; and multiple layers of operating fees and expenses — amount to approximately $15 million annually. Since we do not know how long TSERS has been invested in these unknown private equity fund of funds, we cannot estimate the cumulative undisclosed fees paid over time to these unknown fund managers.

Over a trailing five-year period the TSERS private equity portfolio has underperformed even its forgiving custom benchmark by 4 percent per year, according to Hewitt EnnisKnupp.[125]

---

[124] As discussed further below, the Treasurer's heavy reliance upon Credit Suisse is surprising in light of the SEC's recent charges against the firm for violating the federal securities laws by providing cross-border brokerage and investment advisory services to U.S. clients without first registering with the SEC. Credit Suisse agreed to pay $196 million and admit wrongdoing to settle the SEC's charges.

[125] Investment Fiduciary Governance Commission Briefing Book, January 23, 2013, page 39.

According to research by Cliffwater LLC, another pension consultant, for the 10 years ending June 30, 2011, for 23 reporting pensions, TSERS ranked 23, massively underperforming both the Private Equity Average of 9.3 percent by more than 7 percent, and even underperforming the 3.3 percent annual return for far less risky publicly traded stocks.[126]

6. Global Equity

TSERS has invested $37 billion in approximately 50 Global Equity funds, paying disclosed fees of approximately $94 million in 2013. No incentive fees have been disclosed.

The Treasurer has not disclosed any underlying fees and expenses related to the $130 million in assets managed by Tiger Tar Heel Partners, which appears to be a $140 million public equity manager of managers investment partnership initially funded substantially by TSERS. According to Investment Advisory Committee minutes dated May 30, 2012, the partnership will invest in funds recommended by Tiger. The Treasurer has disclosed asset-based fees of approximately $2 million paid to the firm or approximately 1.5 percent.

Assuming the underlying public equity managers charge asset-based and incentive fees and such fees generally amount to 2 percent and 20 percent respective, we estimate the undisclosed asset-based fees paid to the underlying managers, amount to approximately $2.6 million in 2013. We have not assumed any incentive fees.

---

[126] Trends in State Pension Asset Allocation and Performance, Cliffwater LLC, June 26, 2012.

Assuming trading costs of 2 percent and multiple layers of operating fees and expenses of 1.5 percent, we estimate these hidden fees amount to $4.5 million.

In summary, total asset management (assuming no performance fees whatsoever), brokerage, operating fees and expenses related to the Tiger investment may amount to over $9 million annually—an amount more than three times greater than the $2.6 million in fees disclosed by the Treasurer.

Since TSERS has been invested in the Tiger fund since 2012, total undisclosed fees related to this single manager could amount to $14 million—assuming no performance fees over the past four years whatsoever.

XIV. Past and Present Placement Agent Abuses

A. Controversy and Outrageous Fees Related to Secret Agents

A placement agent is an individual or firm hired to act as an intermediary, or middleman for an asset manager, to market and sell its investment products to investors. Placement agents, as "third-party marketers," are not employees of investment managers subject to continuous manager supervision of their activities. As a result, absent full and complete disclosure, investors are often unaware that placement agents are paid marketers for the managers that have retained them and are ignorant regarding the outlandish amounts of compensation they receive for steering investors.

Placement agent fees are massive in absolute dollar terms, often amounting to millions per institutional investment for only a few hours work.

Further, these avoidable alternative investments marketing fees alone are exponentially greater (10 times or more) than the total fees traditional asset managers charge for actually managing client assets.

As a percentage of the total cost of the management of alternative assets, paying 50 percent to a marketing intermediary is clearly extravagant.

Placement agent fees are generally 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 marketing intermediary. However, placement agent fees may be paid directly by institutional investors.

For example, in one highly publicized case, the Chicago Teachers' Pension Fund balked at paying a marketing fee to a firm owned by Edward M. Kennedy Jr. — a fee that the other 60 institutional investors in the fund had paid.[127]

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, dispensable intermediaries.

The federal securities laws generally require that registered investment advisers, when employing the services of third-party marketers, 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 (or marketer) and the investment

[127] Ponying Up to Camelot, Forbes, April 19, 2004.

adviser, as well 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.[128]

In summary, the disclosure requirements related to SEC-registered 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 our experience, the SEC has required registered investment managers utilizing undisclosed solicitors to offer public pension investors rescission of the investment (including reimbursement of any investment losses) and return of all fees paid. Thus, failure to disclose marketing intermediaries can have severe consequences for investment managers. The damages in these cases are not limited to the amount of the undisclosed compensation to the intermediary; rather, placement agent fees plus any losses or underperformance may be claimed.

Note that TSERS has never pursued any such rescission-based damages recovery with respect to undisclosed placement agent fees, despite enormous underperformance losses. By way of example, on a $100 million account, the 2 percent placement agent fee, as well as say 20 percent losses or $20 million may be claimed.

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

Alternative assets, such as hedge, venture, private equity and real estate investments, by definition lack the transparency and liquidity of traditional, publicly-traded assets.

The fees charged by investment advisers for managing alternative assets are exponentially higher than traditional asset classes. These outlandish fees enable alternative managers to richly compensate intermediaries who raise capital on their behalf. Since the arrangements alternative asset managers establish with placement agents lack the transparency common to traditional asset accounts, customers are kept in the dark — ignorant of the excessive portion of the investment advisory fee that will be paid to the intermediary for little but marketing to them.

Placement agents are generally[129] compensated by managers[130] based upon a percentage of the amount of capital raised or committed. Compensation is typically between one and two percent of the commitment, but may be substantially greater — 3 percent or higher,[131] and is usually paid over an agreed upon period of time.[132]

For example, the placement agent fee related to a $200 million investment may be an astronomical $6 million, 25 percent or $1.5 million payable upon closing of the investment, and the remaining balance payable over the next three years—compensation which is

[129] Note that while there are apparent industry norms for placement agent compensation (based upon limited disclosure of agreements), due to lack of regulation and secrecy related to these arrangements, any type of payment scheme is possible.

[130] As mentioned earlier, institutional investors may pay placement agent fees.

[131] See placement agent disclosure related to TSERS' investment in Patria Brazil Real Estate Fund II.

[132] Additional monthly retainers of, say $5,000 and discretionary bonuses (which may be substantial) are also common.

obviously wildly disproportionate to any limited marketing services provided over the period.[133]

Since the primary or even exclusive service placement agents provide is introducing investment managers to prospective clients based upon pre-existing relationships, placement agents may, and often do, utterly lack any relevant financial expertise.

For example, with respect to the placement agent hired by C.B. Richard Ellis, it is stated, "The review uncovered no evidence that Dworsky had any subject-matter expertise regarding the investments being sold by CBRE or the particular investment needs of NCRS."

With respect to the placement agent retained by Avista, "Avista did not investigate whether Aqueduct had a "due diligence committee" or the capacity to conduct due diligence on Avista Fund II. While it directly retained Aqueduct as its "consultant" and ultimately paid it $1 million for at most a few weeks of work, Avista did not determine whether Aqueduct prepared any due diligence, reports or analysis, whether it had performed any meaningful work, or whether it shared any information or analysis with NCRS." [134]

Some placement agents focus exclusively or primarily on a particular type of investor, such as high net worth individuals, institutional investors, or even public pensions. Placement agents focused upon public pensions have established relationships with elected officials and trustees overseeing these assets, including as significant donors to their and allied political campaigns. As a result, use of placement agents in

[133] Because they are compensated in this manner, placement agents are regulated by both the United States Securities and Exchange Commission and the Financial Industry Regulatory Authority.

[134] Kellogg Huber Findings of Fact and Remedial Measures Regarding Avista, C.B. Richard Ellis, Earnest Partners, and Longview Partners, December 11, 2013, pages 4 and 5.

the public pension context is most controversial and potentially dangerous.

Placement agents and the investment managers that retain them maintain that agents provide services of value to institutional investors, such as access to high- demand investment funds, or to minority and women-owned firms; however, the value of such services is, at best, clearly minimal — particularly 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. Investment consultants typically charge large funds far more reasonable fees of less than one basis point — exponentially less than the 1 to 3 percent placement agents charge — and the advice they provide is independent — unlike the promotional information placement agents offer.

Institutional investors that retain investment consultants generally seek to avoid use of placement agents due, in part, to the myriad risks involved in including them in the investment decision-making process, such as:

- The promotional information provided by these marketing intermediaries lacking investment expertise is, at best, conflicted and unreliable;

- Any introductions and meeting facilitation services they may offer are unnecessary;

- The exorbitant fees they charge, which bear little relationship to any services actually provided are impossible for well-intentioned fiduciaries to justify as reasonable; and

- Legal, regulatory and reputational risk concerns are formidable.

Further, with respect to public pensions in particular, "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, is yet another reason to forego or prohibit placement agent involvement.[135]

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 involving placement agents related to public funds have been widely reported in Illinois, New York, California, Ohio and New Mexico.[136]

---

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

Due to mounting grave concerns, on August 3, 2009, the SEC issued a proposed rule that would have banned the use of placement agents. While the New York State Comptroller and New York City Comptroller expressed strong support for the ban on using third parties to solicit government plans, most commenters on the SEC proposed rule, including many representing advisers, broker-dealers, placement agents and solicitors, and some government officials, strongly opposed the ban.[137] Facing stiff industry opposition, the final rule adopted by the Commission did not include a ban.

A number of states, such as California, New Mexico, and Illinois, have enacted legislation regulating the use of placement agents and some public funds have adopted policies banning any use placement agents. Most public funds that have adopted placement agent policies require

---

[136]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

[137] SEC Release No. IA-3043, *Final Rule 206*(4)-5 Political Contributions by Certain Investment Advisers

disclosure of certain prescribed information; however, enforcement of these policies has largely been ineffective.

For example, as discussed more fully below, at TSERS, five years after the adoption of a placement agent policy premised upon full and complete disclosure, compensation amounts paid to agents remain secret; indeed, managers are permitted to designate payments as "trade secrets."

In summary, despite widespread awareness of the proven risks and unjustifiable billions in avoidable costs involved in using placement agents, the industry has successfully resisted efforts to end placement agents abuses related to public funds nationally. However, most recently, New York City Comptroller Scott Stringer, who oversees $150 billion in pension assets, called for expanding a ban on agents who solicit investments for the city's five pension funds.[138]

B. Pay-to-Play and Placement Agent Abuses Continue at TSERS

Since Treasurer Cowell assumed her responsibilities in 2009, her office, as well as other offices of state government (such as the North Carolina Department of Justice), have spent a protracted amount of time and resources supposedly addressing pay-to-play and placement agent matters. Tellingly, simply banning payments to these at-a-minimum problematic dispensable intermediaries has never been seriously considered.

Further, as discussed below, the Treasurer has paid several consulting and law firms millions to review pay-to-play and placement agent payments at TSERS, as well as make elaborate recommendations going forward to facilitate the continued use of placement agents.

[138] NYC Comptroller Will Widen Ban on Pension Placement Agents, Bloomberg Personal Finance, January 30, 2014.

The effort to ensure compliance with the voluminous policies and procedures the Treasurer has adopted to facilitate the continuation of payment of placement agent fees into the future will involve even greater resources and costs. For example, the plaintiff class action law firm of Cohen Milstein, the partners at which have made political contributions to the Treasurer, has been retained as Compliance Counsel.[139]

There is scant evidence in the record of any benefit derived from placement agents or justification for these added costs.

While the Treasurer publicly acknowledged the importance of adopting a pay-to-play and placement agent policy in 2009, disclosure has not meaningfully improved and her investigation of placement agent abuses has languished for the past five years. Placement agent controversies remain profoundly unresolved.

Rather than promote transparency and accountability regarding placement agent usage at TSERS, the record reveals that the Treasurer has intentionally withheld damning information from the public since taking office.

C. Treasurer Conceals SEC Inquiry into Placement Agents

At the outset of this investigation, we requested copies of any documents related to any correspondence since January 1, 2008, between the Treasurer's office and/or TSERS and the SEC; the Federal Bureau of Investigation; or any other securities regulator or law enforcement agency related to TSERS or its investments, in order to evaluate any information the Treasurer may have provided to these

[139] According to Brian Balfour, Policy Director for the Raleigh-based government watchdog group the Civitas Institute, State Board of Elections records indicate Cohen Milstein employees donated $5,000 to sole pension trustee North Carolina Treasurer Janet Cowell's campaign fund in 2012.

agencies related to improper payments and whether the information the Treasurer has disclosed to the public is consistent with those communications.

According to limited information provided by the Treasurer, on May 8, 2009, the SEC sent a Letter of Inquiry to the Treasurer's office requesting information about certain public pension activities, including use of placement agents at TSERS.

The Treasurer did not disclose to the public that an SEC Letter of Inquiry had been received regarding placement agents at TSERS at that time or at any time subsequent.

Worse still, the Treasurer requested pursuant to 17 C.F.R. Section 200.83 that neither the cover letter nor any other documents provided by the Treasurer in connection with the SEC inquiry be released in response to a request under the federal Freedom of Information Act. The Treasurer even asked to be given at least 10 days prior notice and an opportunity to object to the Commission to the granting of any Freedom of Information Act request and, if necessary, to seek an appropriate protective order in the courts.[140]

The Treasurer declined our request for a copy of the Letter of Inquiry from the SEC and merely provided her responses to the questions asked by the SEC.[141]

[140] Letter from Jay Chaudhuri to Mark R. Zehner, SEC. June 5, 2009. The letter also stated that the Treasurer, by providing this information, was not waiving any attorney-client privilege or any other privilege or immunity from disclosure that may be applicable.

[141] In connection with our forensic investigation of the Rhode Island state pension, the Treasurer of Rhode Island provided us with a copy of the Letter of Inquiry from SEC that the Commission sent to numerous larger public pensions around the country, including North Carolina.

While the SEC requested information regarding placement agents since 2001, the Treasurer only provided incomplete information regarding agents from 2006 through 2008.

The Treasurer represented to the SEC that TSERS paid no placement agent fees; all placement agent fees were paid by the investment managers. To date, the Treasurer has not disclosed any placement agent fees paid by TSERS directly and has not responded to our request for this information.

As opposed to conducting a vigorous investigation in response to SEC concerns, the Treasurer merely "speculated" regarding individuals she believed might be placement agents and did not "attempt to ascertain whether they were registered broker-dealers with the SEC."
With respect to TSERS managers that admitted paying placement agents, the Treasurer failed to disclose to the SEC the compensation paid to the agent by the manager as requested by the SEC and instead repeatedly noted in her response to the SEC "terms of placement agent fee not disclosed by manager."

That is, the Treasurer failed to disclose even a *single* placement agent payment amount to the SEC.

D. Treasurer Ignores Ennis, Knupp Fee Disclosure Recommendations

Immediately after receiving the SEC letter of Inquiry (and without disclosing the SEC Inquiry to the public), in June 2009, the Treasurer retained the former Ennis, Knupp & Associates, Inc. to conduct a supposedly independent review and evaluation of the TSERS, including the use of placement agents.[142] According to published reports, the cost

[142] As noted earlier, at this time Benchmark was conducting an investigation in Alabama involving Aon, Ennis Knupp's parent.

of the review and related investment advice was approximately $1 million.[143]

The April 2010 Ennis Knupp review found that under the practice prior to September 2009, TSERS only tracked placement agents used by private equity and real estate investment managers by the name of the fund, the date of the commitment, and whether a placement agent was used by the investment manager. Information such as the fees paid to the placement agent, whether the placement agent is registered, or whether the placement agent gave any political contributions or gifts to decision-makers, was not included.[144]

The omission of the above details with respect to private equity and real estate managers is fatal to any legal, regulatory or economic analysis. For example, the amount of placement agent fees paid is a significant factor in determining whether the compensation paid to the agent is reasonable in relation to any legitimate financial service provided, as well as in calculating the lower asset management fee TSERS would be able to negotiate with the manager absent the involvement of the dispensable intermediary.

EnnisKnupp did not comment upon the glaring failure to collect the most meaningful placement agent information with respect to all alternative funds, including any hedge and venture capital.

According to EnnisKnupp, in response to a request from the Treasurer, the firm provided a sample agent policy in July 2009 for the Treasurer's

---

[143] Treasurer spending $1M for review, investment advice, http://world-currency.us/index.php?mod=article&cat=Investment&article=3201

[144] Independent Review and Evaluation of the North Carolina Retirement Systems, EnnisKnupp, April 19, 2010, page 14.

review and consideration. While the SEC's proposed rule banning the use of placement agents was, according to EnnisKnupp, one of many factors considered by the Treasurer with regard to development of a policy, a straightforward ban as certain other prominent state pensions had already implemented, was rejected.

Instead, EnnisKnupp opined that "placement agent usage by investment managers is *acceptable* (emphasis added) when reputable agents have proper FINRA registration and can comply with eligibility disclosure requirements."[145] As a result, a detailed disclosure regime, rather than a ban, was proposed," wrote Ennis.

While appropriate licensing and registration of "reputable" placement agents, accompanied by full disclosure of financial arrangements and compensation paid may be legally defensible, there is no reason pension fiduciaries should, in our opinion, consider such controversial, opaque schemes absent a showing of compelling benefit provided by the costly and unreliable dispensable intermediary.

The EnnisKnupp review did not mention any meaningful service provided by placement agents to pensions (as opposed to the marketing services they provide to managers) that could not be procured more reliably from an alternative objective, independent source — at a far less extravagant cost. No analysis was provided indicating that any pension fiduciary had determined, consistent with its applicable legal duties, the fees paid to agents were reasonable. Rather, the firm summarily stated "research shows that the use of placement agents is common."[146]

---

[145] Id.

[146] Id. page 13.

Whether a practice is common or not, in our opinion, is not relevant to whether it is advisable or consistent with applicable fiduciary duties.

Paying millions in state retirement plan assets to dispensable intermediaries for doing virtually nothing obviously offends fiduciary sensibilities and is, in our opinion, impossible to defend.

On September 29, 2009, Treasurer Cowell, in her first year in office, approved the first Placement Agent, Political Contribution, and Connection Disclosure Policy. The placement agent policy called for disclosure and documentation of the fees paid to placement agents related to TSERS investments to the Treasurer but notably did not mandate disclosure to the public.

EnnisKnupp recommended in April 2010 that to promote transparency and accountability, details regarding the placement agent compensation, as well as other important information, including the Disclosure Letter template or specific responses provided to the Treasurer's Office by fund managers and placement agents, be posted on the Treasurer's website for disclosure to the public.[147]

While the Treasurer's Office implemented certain of EnnisKnupp's recommendations from the April 2010 report, it did not and still has not implemented the key recommendation regarding placement agent public disclosures called for by best practices, according to Ennis.

Worse still, the policy adopted expressly permits an investment manager or placement agent to designate as a trade secret under North Carolina law the placement agent identity, services and compensation.[148] As discussed below, in response to our recent public

[147] Id. page 16.

[148] "Website Posting**.** Disclosure Letters shall be public documents. Any designation by an Investment Manager or Placement Agent of Disclosure Letter text as a trade secret under N.C. Gen. Stat. § 132-

records request, the Treasurer withheld placement agent disclosures regarding 16 managers, including even the letter from one manager requesting the trade secret designation.

In conclusion, in 2009 the Treasurer adopted a policy recommended by EnnisKnupp permitting “acceptable” placement agent payments subject to appropriate disclosures; however, the requisite disclosures recommended for transparency and accountability or, to use EnnisKnupp’s word, “acceptability,” have never been made to the public.

E. Kellogg Huber Review Raises More Questions

The December 16, 2013, Report Concerning Placement Agent Review issued by the Office of the Treasurer, almost five years after the adoption of the first Placement Agent Policy is confusing, troubling in many fundamental respects, discloses only minimal, highly unreliable information and raises far more questions than it answers. The report is, for the reasons stated below, in our opinion, likely to mislead, rather than inform, the public.

The Executive Summary prepared by the Treasurer’s office initially states that subsequent to adoption of the Placement Agent Policy in 2009, all *new* external investment managers were required to disclose the retention of placement agents and related information and the Treasurer requested *existing* investment managers to voluntarily disclose the historical use of placement agents in connection with

---

1.2(1) shall be supported by a statement identifying how the text designated as a trade secret satisfies the test of N.C. Gen. Stat. §§ 66-152(3)(a.),(b.) and 132-1.2(1)(b.)-(d.). On a quarterly basis, the Department shall electronically collate Disclosure Letters for all proposed Investment Transactions that were accepted and signed by the Treasurer and make such collations available through its website and other means.” Placement Agent, Political Contribution, and Connection Disclosure Policy, page 5.

presently effective agreements. In response to the Department's voluntary request, "*virtually all* (emphasis added) investment managers provided Placement Agent Policy Disclosure Forms."[149]

It is then cryptically stated that, "In July 2010, based upon the information provided by the investment managers, the Department's General Counsel, in consultation with its outside counsel Womble Carlyle Sandridge & Rice, LLP, sent follow-up correspondence seeking further clarification about these managers' use of placement agents."[150] In late July 2010, the General Counsel received information from "*an* (emphasis added) investment manager that raised concerns; these concerns were then promptly shared with the North Carolina Department of Justice ("NCDOJ")."[151]

The fact that the Womble Carlyle law firm continues to serve as outside counsel to the Treasurer regarding potentially problematic pay-to-play matters is ironic and surprising. As noted by Forbes in 2007, to handle the magazine's inquires regarding improper political contributions from asset managers, in an "almost comical" move, "Moore's office retained the Durham, N.C. law firm of Womble Carlyle Sandridge & Rice, and it turns out lawyers from that firm kicked in $34,560 to Moore's campaigns."[152]

---

[149]Report Concerning Placement Agent Review, December 16, 2013, Executive Summary page 2. Why some managers refused to provide the placement agent information requested and how the Treasurer handled such refusals is not indicated.

[150] Who these managers were and why further clarification was needed is not stated in the Executive Summary. According to the Kellogg Huber Final Report, discussed below, the responses of certain managers showed potential problems and significant information deficiencies, however, it is not clear from the Final Report that all former and existing, or even all existing, managers were questioned.

[151] Apparently, according to the Executive Summary, only one unnamed manager raised certain concerns to the Treasurer which were shared with the NCDOJ. What those concerns were is not stated.

[152] Pensions, Pols, Payola, Forbes, February 23, 2007.

Evidently the current Treasurer does not consider this history of controversial political contributions by the law firm to her predecessor disconcerting. In fact, political contributions from the firm have continued — only now the contributions are directed to her campaign, not Moore's. In 2011-12, Womble, contributing a total of $21,000, was the Treasurer's second largest donor.[153]

The Executive Summary goes on to state that the Department of State Treasurer and the NCDOJ mutually agreed that the Department of Justice should retain an outside counsel to further review the use of placement agents by Department of State Treasurer investment managers. In December 2010, the Department of Justice retained Kellogg, Huber, Hansen, Todd, Evans & Figel, P.L.L.C. (Kellogg Huber) to serve as the independent counsel in connection with the NCDOJ's review of placement agents.[154]

The Report Concerning Placement Agent Review issued by the Office of the Treasurer does not reveal whether Kellogg Huber, the NCDOJ or any other party has reviewed all placement agent fees paid by TSERS managers over time. We simply cannot know, based upon the limited, cryptic information provided, whether a comprehensive review was undertaken of placement agents related to all current and former managers and whether all questionable arrangements have been thoroughly reviewed and disclosed.

---

[153] According to the Influence Explorer website, the Treasurer's two biggest sources of donations in 2011-12 were from the plaintiff class action law firm of Bernstein Litowitz ($34,000) and Womble Carlyle.http://influenceexplorer.com/politician/cowell-janet/83e98ccba92f4f159a1ab093dd498cfe?cycle=2012

[154] According to the firm's website, the Kellogg Huber firm represents "large banks and other financial services firms; private equity firms and their portfolio companies." Thus, in our opinion, the firm appears to be subject to a potential conflict of interest and may not be ideally-suited to conduct a truly "independent" review of controversial pervasive practices, such as the payment of placement agent fees, which the private equity industry relies heavily upon in its marketing.

The Executive Summary states that, "As part of the Special Review, from January 2011 to October 2013 investment managers and placement agents provided documents to or held fact interviews with the Department of Justice and Kellogg Huber."[155] Further, "A series of fund commitments entered into between 2002 and 2008 became the focus of the Kellogg Huber review. These commitments which were made prior to Treasurer Cowell's first term."[156]

"In April 2013, the NCRS received initial documents from the Department of Justice. That same month, the NCRS through the Department and Kellogg Huber contacted nine investment managers based on information from the Special Review," says the Executive Summary.

Both the Kellogg Huber Final Report[157] and Findings of Fact[158] warn readers at the outset regarding "significant caveats."

First, the law firm lacked authority to employ "normal investigative tools, such subpoenas or civil investigative demands" and the findings of fact released to the public merely summarize the facts voluntarily disclosed using the limited tools available.[159]

---

[155] For approximately six months, from January through June 2011, NCDOJ took the lead on the review without substantial input from Kellogg Huber, for reasons that are not explained. Further, as mentioned below, the NCDOJ did not share with Kellogg Huber all of the information it had obtained from the managers and placement agents.

[156] The final sentence in this quote from the Executive Summary prepared by the Treasurer's office is both gratuitous and reveals, in our opinion, a political agenda.

[157] Special Review for the North Carolina Department of State Treasurer, Final Report, December 11, 2013.

[158] Special Review for the North Carolina Department of State Treasurer, Findings of Fact and Remedial Measures Regarding Avista, C.B. Richard Ellis, Earnest Partners, and Longview Partners, December 11, 2013.

In our opinion, it is inexcusable that a costly review[160] involving billions in public pension assets was delayed for years and finally conducted without the power to subpoena documents and without the power to compel testimony. By instituting civil actions against the suspect investment managers, as a matter of right the pension could have conducted discovery, issued subpoenas and compelled testimony—thereby enhancing the completeness and accuracy of the fact-finding. Further, given that this incomplete, inconclusive review took over three years, civil investigative devices would not have involved any greater time.

Second, the Executive Summary mentions that concerns regarding placement agents have been shared with the NCDOJ but does not disclose these specific concerns[161] and the Findings of Fact warns readers that the NCDOJ did not provide Kellogg with all of the documents that it received from those third parties.[162] No explanation is provided as to why NCDOJ did not provide Kellogg with all of the documents relating to abuses at TSERS.

Third, as a result of the above caveats, Kellogg Huber warns readers of the Findings of Fact report that "these findings can be neither corroborated nor refuted by facts not voluntarily disclosed, and there is no guarantee that the findings are either complete or accurate ... Given these limitations, we note *with great emphasis* (emphasis added) that

---

[159] Special Review For the North Carolina Department of State Treasurer, Final Report, page 1 and Findings of Fact Report, page 2. "It is important to point out significant caveats about these findings of facts. This special review was conducted without the power to subpoena documents and without the power to compel testimony.

[160] It is our understanding that the Kellogg Huber review cost TSERS approximately $1 million.

[161] Executive Summary, page 2.

[162] Findings of Fact, page 2.

this report draws no conclusion about whether the facts set out below could be construed to violate any criminal or civil laws."[163]

In conclusion, the Report Concerning Placement Agent Review issued by the Office of the Treasurer is so deeply flawed — so riddled with profound caveats — that it cannot be regarded as a serious fiduciary response, albeit years late, to the history of outrageous placement agent abuses at TSERS and the concerns of stakeholders.

In our opinion, at best, this superficial investigative effort demonstrates a lack of coordination and decisiveness; at worst, an intention to delay disclosure of, obscure and understate improper payment schemes.

The unverified, voluntary information discussed in the Report Concerning Placement Agent Review issued by the Office of the Treasurer relates only to a handful of the hundreds of managers hired by TSERS over the past decade and all prior to the current Treasurer taking office.

Worse still, for reasons that are not explained, the Findings of Fact come from two sources[164]and those summarized by the Treasurer's General Counsel do not even mention the amount of any placement fees paid with respect to Robeco and StarVest[165] or any effort to secure a refund or recovery of any of the $2.4 million placement fee paid by Apollo

---

[163] Id.

[164] The Findings of Fact regarding four investment managers, Avista Capital Holdings, C.B. Richard Ellis, Earnest Partners, and Longview Partners, represent findings by Kellogg Huber; the findings of fact regarding Angelo, Gordon & Company, Apollo Global Management, LLC, Horsley Bridge Partners, LLC , Robeco Institutional Asset Management, StarVest Partners, LLC., represent findings by the Department of State Treasurer.

[165] According to relevant documents on the Treasurer's website, it is possible to estimate that the Robeco placement agent fee amounted to 2% of $150 million or $3 million and the StarVest fee amounted to 1.5% of $30 million or $450,000.

Global Management. Thus, the Findings of Fact summarized by the Treasurer's General Counsel fail to address approximately $6 million in placement agent fees.

The Executive Summary states that "over the last eight months, the NCRS has entered into agreements with eight of the nine investment managers resulting in a combination of either financial compensation back to NCRS or policy changes or both. Three firms have agreed to almost $15 million in refunds and fee discounts to the NCRS."[166]

While $15 million in refunds and fee discounts to the NCRS is mentioned, little if any monies had actually been recovered from these managers and paid back into the pension to date; rather, future payments from managers — only over a period of years once fees become due, and prospective fee reductions have been secured with managers who will be permitted, despite their serious transgressions, to continue to manage existing, or even greater, TSERS assets.

Further, with respect to the $1.4 million placement agent fee paid in connection with the C.B. Richard Ellis Global Investors investment, no refund or discount was negotiated and TSERS will keep $150 million invested in the partnership, without any further action.[167] This seems remarkably inequitable since C.B. Richard Ellis and Earnest Partners paid the same individual placement agent — who reportedly had no subject matter expertise and did not perform any due diligence or substantive work — and Earnest, which paid the agent far less - $218,000 - agreed to "rebate" almost three times the amount of the fee or $600,000 in management fees.

---

[166] The Executive Summary for Kellogg Huber Special Review page 3.

[167] The Findings of Fact summarily state "NCRS is bound by the terms of the Limited Partnership Agreement that governs its current investment with CBRE, and is therefore unable to exit that existing investment.

The Executive Summary for the Kellogg Review states placement agents' fees are paid by investment managers, not fund investors like TSERS but subsequently acknowledges "it was appropriate to deposit the $15 million in fees recovered from managers back into the TSERS as investment fees because "such fees and expenses might have been lowered in the absence of the original placement agent fee."
That is, the remedy selected to cure the wrongdoing reflects that placement agent fees are in fact, albeit indirectly, paid by investors and ultimately result in higher fees to pension clients.

In its Final Report, Keller Huber called upon the Treasurer to disclose both placement agent compensation amounts, as well as post the Disclosure Letter template and specific responses provided to the Treasurer's office by fund managers and placement agents on the website — both of which were originally recommended in the April 2010 EnnisKnupp review and ignored by the Treasurer for over three years.[168]

In response to these outstanding items, the Treasurer's office indicated "Effective December 10, [2013] the Department will post placement agent information online. The disclosure letter template is posted on the Department's website." With respect to each response, Keller Huber states, "The Department's Response adequately addresses the Recommendation."[169]

F. Failure of Archive of Placement Agent Policy Disclosure Letters

The Archive of Placement Agent Policy Disclosure Letters Submitted by Investment Managers on the Treasurer's website, in our opinion, does

[168] Final Report, page 19.

[169] Appendix of Recommendations, Responses, and Resolutions, page A-19.

not adequately address EnnisKnupp and Kellogg Huber recommended disclosures and is wholly unresponsive to stakeholder concerns.

Poorly constructed and needlessly confusing, the Archive fails to provide any useful information.

While placement agent fees have been paid since as early as 2002, the Archive does not appear to include letters regarding all investments going back to that point in time. Further, many letters referenced in the Archive are not provided, incomplete, or inaccurately described.

For example, a very cursory review of the Archive postings revealed the following obvious deficiencies:

Link Issues:

- Oaktree European Principal Fund III — link to the referenced disclosure letter indicating a placement agent had been used led to a letter from another firm, Novak Biddle Venture Partners, stating that no placement agent fee had been paid.
- Silverback Arbitrage Fund — no link to the two letters referenced indicating a placement agent had been used.
- JER Real Estate Partners Fund III L.P. — no link to the letter referenced indicating a placement agent had been used. Description of fee on website omits mention of $2 million-plus fee stated in letter.
- Magnetar Constellation Fund IV — link to letter was inoperative.
- WCP Real Estate Fund III — link to letter inoperative.

- Intervale Capital Fund II — link to the referenced disclosure letter indicating a placement agent had been used inoperative.

- HG Capital 7 — link to letter indicating that placement agent was involved inoperative.

- Terra Firma Deutsche Annington, L.P. — no link to letter indicating that placement agent was involved.

Incomplete Disclosures:

- Westbrook Real Estate Fund I, Fund II,[170] Brookfield Real Estate Finance Fund III — while it is disclosed that fees were paid, no compensation amounts are stated.

- Castle Harlan Partners IV and V — the name of the "unknown" individual at the placement agent who "has been calling upon the employees of the Department over the past years" has not been provided.

- Catterton Partners VII — name of the individual at placement agent unknown.

- Perella Weinburg Partners — compensation of placement agent not disclosed.

Incorrect information:

[170] The placement agent with respect to Westbrook Real Estate Fund I and Fund II was acquired by Credit Suisse.

- Perseus Market Opportunity Fund — incorrectly states that no placement agent was used when, in fact, Credit Suisse was paid a placement agent fee.[171]

- Catterton Partners II — $1.5 million fee omitted on website.

- Burrill Life Sciences Capital Fund III, L.P. — retainer understated on website; Burrill Life Sciences Capital Fund III, L.P. and Burrill Life Sciences Capital Fund, L.P. — $3 million success fees omitted on website.

In summary, even a cursory review reveals that public disclosure of placement agent fees in the Archive on Treasurer's website is not a priority and either no one is reviewing the disclosure letters for compliance or compliance is not effectively enforced.

In response to an email to the Treasurer's office regarding a few of the above deficiencies, we were told that a review by the Treasurer's office had determined that the summary table on the website contained errors and the website would be updated to correct the errors. Further, "because the hyperlinks on the Placement Agent Policy disclosure letter website have been difficult to maintain, we are in the process of converting that part of the website to a new format. We expect the revised website to be brought online in the next few days."[172]

The Archive on the website does not disclose the number of investment managers who have responded or the number that have paid placement

[171] As discussed below Credit Suisse has multiple, extensive relationships with the Treasurer's office, both as an asset manager and as a placement agent.

[172] Email from Schorr Johnson, Department of State Treasurer Communication Manager, February 6, 2014. To the contrary, as of April 17, 2014, the link to the Archive on the Treasurer's website is entirely inoperable.

agent fees. Our review of the website indicates that approximately 80 investment managers responding have paid fees.

Contrary to statements by the Treasurer,[173] placement agent fees are not limited to 1 to 2 percent but some amount to 2.5 percent[174] and 3 percent[175] or more.

In the overwhelming majority of cases, the actual dollar amount of the fee paid to the placement agent is not disclosed in the Archive or anywhere else. Rather, elements of the compensation paid, e.g., 2 percent of assets raised plus a monthly retainer (say, $5,500), discretionary incentive bonus, travel, entertainment, mailings, and office expenses are listed, but the actual total dollar amount paid to the placement agent, is not disclosed. Adding to the uncertainty, at least one manager waived a portion of its $3 million fee in exchange for an unknown portion of the General Partner's carry which may have resulted in a far greater undisclosed fee.

Some of the individual placement agent fee amounts disclosed in the Archive involve millions, e.g., $7.4 million for RLJ Real Estate Fund III; $5.5 million KRG Capital Partners II; $4.9 million for KRG Capital Partners III; and $3.3 million for RLJ Lodging Fund II, L.P. Again, most of the million-plus actual placement agent fee amounts paid can only be estimated because they are not disclosed to the public.

Most alarming, with respect to 16 alternative investments made by TSERS, the Archive indicates that the external managers involved have

[173] NC pension fund to strengthen transparency measures for 'placement agents,' newsobserver.com, December 16, 2013.

[174] See Mount Keller Capital Management LP.

[175] See Pátria Brazil Real Estate Fund II.

been permitted to designate the compensation arrangements they have entered into with third-party placement agents, disclosed or not disclosed, as "trade secret" under North Carolina law.[176] There is no

---

[176] Terra Firma Investments II and III: Fee only designated as trade secret. The placement agent firm, not individuals, is disclosed on Treasurer's website and in linked Disclosure Letter with redactions. Fee disclosure has been redacted. Name and background of individuals, services provided and fees cannot be reviewed for compliance.

Crossharbor Institutional Partners LP and II: Fee only designated as trade secret. While name of placement agent firm is disclosed on Treasurer's website for both offerings, there is no link to Disclosure Letters, even though entire letter has not been designated as trade secret. Name and background of individuals, services provided and fees cannot be reviewed for compliance.

DLJ Real Estate Capital Partners: Fee only designated as trade secret. While Treasurer indicated in a letter to us only one DLJ fund has designated fee as trade secret, the Treasurer's website indicates four DLJ Real Estate funds (I through IV) "designate as confidential" and there are no links to any of the four Disclosure Letters. Name and background of individuals, services provided and fees cannot be reviewed for compliance.

Frogmore Real Estate Partners I and II: Fee only designated as trade secret. While name of placement agent firm is disclosed on Treasurer's website for both offerings, no link to Disclosure Letters. Name and background of individuals, services provided and fees cannot be reviewed for compliance.

Halifax Investment Management II: The entire 14-page letter to the Treasurer has been redacted. Name of firm, and background of individuals, services provided and fees cannot be reviewed for compliance.

Harvest Advisors: Fee only designated as trade secret. While name of placement agent firm is disclosed on Treasurer's website, the entire Disclosure Letter, linked to website, is redacted. Name and background of individuals, services provided and fees cannot be reviewed for compliance.

HG Pooled Management: Fee only designated as trade secret. While name of placement agent firm is disclosed on Treasurer's website, the link to the Disclosure Letter is broken. Name of firm and background of individuals, services provided and fees cannot be reviewed for compliance.

Intervale: Fee only designated as trade secret. While name of placement agent firm is disclosed on Treasurer's website, the link to the Disclosure Letter is broken. Name of firm and background of individuals, services provided and fees cannot be reviewed for compliance.

Terra Firma DA: Fee only designated as trade secret. The placement agent firm, not individuals, is disclosed on Treasurer's website but there is no link to the Disclosure Letter. Name of firm and background of individuals, services provided and fees cannot be reviewed for compliance.

public disclosure regarding these select managers' arrangements with placement agents. With respect to majority of the 16 "secret" fee arrangements, Credit Suisse Securities is listed as the placement agent.[177]

In summary, the placement agent fee amounts paid by each TSERS manager and the total amount of placement agent compensation, to date, have not been disclosed to the public on the Treasurer's website, or anywhere else. The incomplete information provided to the public on the Treasurer's website is so disorganized and unreliable that it can only confuse and mislead the public.

Assuming that the Treasurer has enforced compliance with the placement agent policy (which requires disclosure of the fees paid), the relevant information is readily-available —I ndeed already known to the Treasurer.

It appears that for the past five years the Treasurer has intentionally withheld from public scrutiny arguably the most significant information regarding placement agent fees — the fact that TSERS has secretly squandered a staggering estimated **$180 million** in avoidable fees.[178]

G. Treasurer Fails to Provide SEANC Placement Agent Fee Details Requested

On January 10, 2014, SEANC requested that the Treasurer provide copies of any documents related to the payment of any compensation

---

Angeleno Group: No disclosure of even firm name. Name of firm, individuals, services provided and fees cannot be reviewed for compliance.

[177] See discussion below regarding our concerns related to the current and former Treasurers' extensive opaque and controversial dealings with Credit Suisse.

[178] As indicated below, this estimate may be significantly lower than the actual amounts paid.

paid to intermediaries, including but not limited to placement agents by TSERS or any of its investment managers for the period from January 1, 2003 through January 2014 and disclose with respect to each payment and arrangement, the party making the payment; the services provided in exchange for the payment; the party receiving the payment and the amount of the payment.

To date, the Treasurer has failed to provide any additional information regarding the 16 investments that the external managers involved had been permitted to designate the compensation arrangements as "trade secret" under North Carolina law. Most important, the actual dollar amounts paid to placement agents per transaction and in total have been withheld.

With respect to additional documents related to payments to a placement agent or other intermediary by a party other than the investment managers, such as placement fees related to a given investment paid directly by TSERS, despite repeated requests, no information has been provided.

H. Total Secret Placement Agent Fees Exceed $180 Million

According to statements attributed to the Treasurer,[179] a staggering 50 percent of TSERS managers pay placement agent fees that range from 1 percent to 2 percent.

As discussed above, our research reveals that TSERS placement agent percentages *alone*, in fact, range as high as 3 percent. In addition to the percentage fees, there are monthly retainers, expenses and discretionary bonuses included in the agent's total compensation. We

[179] NC pension fund to strengthen transparency measures for 'placement agents,' newsobserver.com, December 16, 2013.

have not factored these amounts, which may be significant, in our estimate.

For purposes of our estimate, we assume the Treasurer meant 50 percent of the alternative managers, not half of *all* TSERS managers, pay placement agent fees. If any such placement agent fees have been paid with respect to so-called traditional investments, then the amount of undisclosed fees could amount to hundreds of millions more.
We note that since the Treasurer has failed to categorize certain alternative managers as such, our estimate is likely to be lower than the actual amount of placement agent fees paid.

Assuming half of the alternative investment managers managing approximately 21 percent of TSERS assets (approximately $9 billion) pay placement agent fees of (on average) 2 percent of assets, the estimated total placement agent fees paid amount to approximately **$180 million**. Turnover of managers since 2002 (which we have not factored into the analysis), as well as dramatically increasing the allocation of assets to alternatives, generally causes the amount of placement agent fees paid to increase.

I. Need for SEC Investigation

Due to the highly significant amounts secretly paid for questionable so-called investment services and the Treasurer's apparent unwillingness to disclose such placement agent compensation amounts to stakeholders — even as required under applicable state law—we recommend further investigation by the SEC is needed at this time.

XV. Dubious North Carolina Nexus Investments and Influence-Peddling

A significant portion of TSERS's alternative investments, including but not limited to the North Carolina Innovation Fund and the other Credit Suisse/North Carolina funds, are invested in private equity funds and companies that are based in North Carolina. Both the current and prior Treasurer have/had policies giving preference to local funds and enterprises.

Pension policies targeting local businesses give rise to heightened concerns regarding potential improper relationships between locals and pension decision-makers that may result in imprudent investments.

In our opinion, many of the local private equity funds and companies in which TSERS has invested clearly lacked the requisite relevant experience and track records generally required by pensions. Not only did TSERS "seed" many of these funds and businesses apparently lacking merit, it continued to leave substantial assets at risk in these funds and firms long after, in our opinion, it became apparent that their services were uncompetitive.

In our opinion, an investigation by law enforcement and the SEC into the facts and circumstances related to many of the North Carolina nexus investments should be undertaken and would reveal imprudent decision-making based upon improper relationships, as well as outrageous profiteering.

.

XVI. Treasurer's Heavy Reliance upon Troubled Credit Suisse

As mentioned earlier, with respect to the majority of the 16 fee arrangements that the Treasurer refused to disclose to us, Credit Suisse Securities is listed as the placement agent.

In addition to earning substantial secret placement agent fees, Credit Suisse Securities is one of the top brokers earning trading commissions from TSERS.[180]

Further, the firm is extensively involved with TSERS as an asset manager. In 2010, the Treasurer hired Credit Suisse to manage the $230 million North Carolina Innovation Fund.[181]

TSERS has also invested approximately $381 million in the Credit Suisse Enhanced Fund; $176 in the CS/NC Investment Fund 2006; $89 million in the Credit Suisse Innovation Fund; $102 million in the CS/NC Investment Fund 2008; $18 million in the CS/NC Investment Fund 2008- Series II; and an unknown amount in the CS/NC Investment Fund 2011.

Clearly, Credit Suisse, a firm which has a significant presence in North Carolina in the form of 1,000 employees based in the Research Triangle Park has/had a substantial, complex, secretive and highly lucrative relationship with both the current and past Treasurer. Due to the variety of investment services provided, the relationship is fraught with myriad potential conflicts of interest. Further, managing the investment funds that target North Carolina enterprises is a pivotal, potentially politically sensitive assignment.

Recently, on February 14, 2014, the SEC announced charges against Zurich-based Credit Suisse Group AG for violating the federal securities laws by providing cross-border brokerage and investment advisory services to U.S. clients without first registering with the SEC.

---

[180] Annual Report 2013, https://www.nctreasurer.com/inside-the-department/Reports/NCDST_Annual_Report_FY2012-2013.pdf

[181] Credit Suisse to manage N.C. Innovation Fund, http://www.wral.com/business/story/7235603/

Credit Suisse agreed to pay $196 million and admit wrongdoing to settle the SEC's charges.

According to the SEC's order instituting settled administrative proceedings, Credit Suisse provided cross-border securities services to thousands of U.S. clients and collected fees totaling approximately $82 million without adhering to the registration provisions of the federal securities laws. Credit Suisse relationship managers traveled to the U.S. to solicit clients, provide investment advice, and induce securities transactions. These relationship managers were not registered to provide brokerage or advisory services, nor were they affiliated with a registered entity. The relationship managers also communicated with clients in the U.S. through overseas emails and phone calls.[182]

The SEC is also currently investigating whether Credit Suisse Group AG improperly shifted money in its private banking unit to obscure a drop in asset growth amid a U.S. probe of tax evasion at Swiss Banks.[183]

Recently a probe into alleged manipulation of foreign exchange markets stepped up when two European regulators intensified their efforts to find out whether banks, including Credit Suisse, rigged crucial financial benchmarks.

Switzerland's competition watchdog became the first regulator to publicly confirm it had uncovered signs of illegal activity as it announced an investigation into possible forex manipulation by eight banks. Meanwhile, the UK's financial regulator said it was examining the

---

[182] Credit Suisse Agrees to Pay $196 Million and Admits Wrongdoing in Providing Unregistered Services to U.S. Clients, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540816517

[183] Credit Suisse Said to Face SEC Probe of Accounting Moves, http://www.bloomberg.com/news/2014-02-26/credit-suisse-said-to-face-sec-probe-of-accounting-moves.html

controls investment banks have in place to prevent traders from rigging benchmarks.[184]

Last month, the firm agreed to pay $885 million to settle claims it mis-sold mortgage-backed securities in the U.S. before the financial crisis.

The firm disclosed in its recent annual report filing that it has increased the funds it has set aside to settle a U.S. tax dispute and avoid prosecution for helping wealthy Americans hide cash from the taxman, raising the prospect it may be close to a settlement in the lengthy dispute.[185]

In our opinion, in light of the TSERS's longstanding heavy reliance upon Credit Suisse — a firm involved in numerous grave regulatory controversies this time; the variety of services the firm provides and the myriad potential related conflicts of interest, further investigation of the relationship between the Treasurer, TSERS and the firm is merited at this time.

[184] Swiss, UK watchdogs step up forex investigations, http://gulfnews.com/business/banking/swiss-uk-watchdogs-step-up-forex-investigations-1.1312312

[185] Credit Suisse increases provision for U.S. tax deal, http://compliancex.com/credit-suisse-increases-provision-for-u-s-tax-deal/

About Benchmark Financial Services, Inc.

Founded in 1999, Benchmark Financial Services, Inc. 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.

Benchmark was founded by Edward Siedle in 1999. 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.

Siedle 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. Siedle writes a "Financial Watchdog" column for Forbes.com He is also an active member of the Florida Bar and a retired member of the Massachusetts Bar.

Research assistance provided by Christopher Tobe. Mr. Tobe, CFA, CAIA has more than 25 years of institutional investment experience with a focus on public pension plans. His recent book "Kentucky Fried Pensions" has already become a bestseller on public pensions. He has served as a Trustee and on the Investment and Audit Committees for the $14 billion Kentucky Retirement Systems and was a Senior Consultant with NEPC and AEGON working with a number of public pension plans nationally. While at Fund Evaluation group Tobe worked with public university endowments. From 1997-1999 he worked with Kentucky State Auditor Ed Hatchett. He has published articles on public pension investing in the Financial Analysts Journal, Journal of Investment Consulting, Journal of Performance Measurement, and Plan Sponsor Magazine. He holds an MBA in Finance and Accounting from Indiana University Bloomington and a BA in Economics from Tulane.