

Double Trouble: Wall Street Secrecy Conceals Preventable Pension Losses in Rhode Island

America's First Crowd-funded Forensic Investigation of a State Pension by Benchmark Financial Services, Inc., June 5, 2015.

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I. Executive Summary

When an airplane soaring without a trained pilot crashes, or a boat riddled with leaks sinks, there is no question that the ensuing damage was foreseeable. Twenty-twenty hindsight is not required to conclude these losses were both probable and easily preventable.

Likewise, this forensic investigation into the Employee Retirement System of Rhode Island (“ERSRI”) reveals that investment decisions that were obviously wrong from inception—reckless piloting of public retirement assets into secretive high-risk investments and leakage related to lavishing ever-greater investment fees on Wall Street—are the greatest factors undermining the solvency of the state pension today. Mismanagement and “politicization” of pension investments—not excessive benefits promised to workers—are the chief culprits.

Key Finding:

Redesign of the pension system that was supposed to save taxpayers \$4 billion over 25 years, has already—in the first four years— cost the pension \$1.4 billion.

Total preventable losses identified in this report amount to nearly \$2 billion.

In June 2011, former Treasurer Gina Raimondo (now Governor of Rhode Island) issued a report titled Truth in Numbers: The Security and Sustainability of Rhode Island’s Retirement System which stated at the outset, “Today Rhode Island’s pension plans provide neither retirement security nor financial sustainability and are in dire need of re-design... Each year that the state delays action to address its fundamental structural pension issues, the more risk the system faces and the harder it becomes to fix.”

“As with solving any problem, it is critical to understand the history leading up to a crisis before offering proposals for change. The decisions made by our elected and appointed leaders, both Democrats and Republicans, during the 1960s, 1970s, 1980s and 1990s have caused the current crisis in our pension system. These officials, representing management and labor interests, made decisions based more on politics than policy, which understated the required contributions to the pension plan leaving the state with a significant unfunded pension liability.”

While contributions paid into a pension is a factor in determining the health of a pension (as are benefits paid out to retirees), management of the assets of the pension over the decades is arguably most important.

The history of mismanagement of state pension assets referred to in the report, including the “politics” related to bad investment decision-making were conspicuously missing from Raimondo’s “Truth.”

According to Raimondo, five primary factors that largely created the pension structural deficit were: failing to utilize sound actuarial practices; generous benefit improvements without corresponding taxpayer or employee contributions; current pension plan design; retirees living longer; and lastly, lower-than-assumed investment returns.

Lowering the investment assumption from an 8.25 percent rate of return to 7.5 percent was discussed as a partial solution to closing the gap between assumed and actual performance.

However, Raimondo's intent to "fix" past underperformance through a politically-driven loading-up on the highest cost, most secretive investments ever devised by Wall Street was not disclosed.

In November of 2011, the General Assembly enacted the Rhode Island Retirement Security Act of 2011. Shortly thereafter, all retirees and active employees impacted by the Act initiated litigation contesting the Constitutionality of the reform measure. Among the changes in the Act were a combined defined pension benefit and defined contribution program, a retirement age that matches the Social Security retirement age (with transition rules for those closer to retirement) and cost-of-living adjustments that are tied to the system's funding level and actual investment returns.

According to the Economic Policy Institute, the new legislation represented the worst of both worlds for state workers.

“RIRSA actually lowers benefits for state employees and introduces more risk.”¹

- **“Reform” Has Already Cost Pension \$1.4 billion—\$2 Billion in Total Preventable Losses**

Former Treasurer Raimondo claimed that her redesign of the state pension system would save taxpayers at least \$4 billion over the next 25 years.²

In fact, as detailed below—in its first four years—Raimondo’s flawed investment strategy has already cost the pension approximately \$1.4 billion in foreseeable losses.

In other words, during the former Treasurer’s tenure, gambling in alternative investments cost ERSRI stakeholders almost **\$1 million a day.**

Total preventable underperformance losses identified in this report amount to nearly \$2 billion.

Ironically, thanks to Raimondo’s “pension reform” the sustainability of ERSRI is more precarious than ever.

¹ <http://www.epi.org/publication/ib366-rhode-islands-hybrid-pension-plan/>

² Raimondo Press Release November 3, 2011.

- **Ample Forewarnings Ignored**

To be sure, there were ample forewarnings that heavy reliance on high-risk, high-cost alternative investments was imprudent and these investments should have never been made.

As we noted in our 2013 report *Rhode Island Public Pension Reform: Wall Street’s License to Steal*,³ possibly the world’s greatest investor, the Oracle of Omaha—Warren Buffett—years ago wagered \$1 million that hedge funds would not beat the S&P 500 over the next ten years. Seven years into the bet, the CEO of Berkshire Hathaway is handily winning, as the S&P 500 has more than tripled the hedge fund return.

John Bogle, Founder of the Vanguard Group, in a 2013 Letter to the Editor of the Wall Street Journal warned public pensions that “hedge funds are hardly a panacea.”⁴

As we alerted readers in our prior report:

“The staggering, almost 700 percent planned increase in ERSRI’s investment expenses...from \$11 million to an estimated \$70 million—fees paid to Wall Street hedge fund and other alternative managers—has and will continue to drag down net investment returns...

³ Forensic Investigation of the Employee Retirement System of Rhode Island for Rhode Island Council 94, American Federation of State, County and Municipal Employees by Benchmark Financial Services, Inc., October 17, 2013.

⁴ Wall Street Journal, June 6, 2013.

Worse still, the investment performance of the Fund has lagged behind its peers under the new mix of assets adopted at the Treasurer’s urging in recent years... If the hedge fund managers continue to perform as badly as they have to date, the damage to ERSRI will be substantially greater—hundreds of millions annually.

...the so-called pension reform scheme as executed by the Treasurer (gorging on hedge, private equity and venture capital funds), guarantees investment-related fees paid to Wall Street will continue to climb to approach \$100 million—an outcome which was both foreseeable and foreseen, i.e., intentional.”

Raimondo, the chief fiduciary of the state pension, chose to ignore these very public warnings and—as she accused her predecessors—proceeded to make sweeping investment “decisions based more on politics than policy.”

- **High Commitment to Alternatives Will Increase Shortfall**

This review underscores (as predicted in 2013) that the massive increase in the percentage of assets invested in alternative investments has dramatically **accelerated** pension underperformance.

If unaddressed, ERSRI’s high commitment to alternatives will lead to greater shortfalls in the future—wiping out any savings related to cutting benefits.

- **40 Percent Invested In 150 Alternative Investments**

Contrary to ERSRI financial reports, **40 percent**—not the 25 percent disclosed—of the pension’s assets have been allocated to secretive, high-risk, high-cost alternative investments.

While ERSRI does not reveal the total number of alternative funds in which it invests (directly and indirectly), we estimate there are over **104 funds** in ERSRI’s portfolio. Recently ERSRI began investing in fund of funds each of which, in turn, invests in dozens of underlying funds. Thus, we estimate the number of ERSRI’s direct and indirect alternative investments is skyrocketing toward **150**.

Our investigation concludes that horrific real estate investments over the past decade—the worst state pension real estate performance in the nation—and underperformance related to speculative hedge, private equity and venture investments over the past four years are the chief performance drags.

- **New Treasurer Promises Greater Transparency**

The willingness of Rhode Island pension officials and others (such as the Governor, Attorney General and Auditor General) to agree to an unprecedented secrecy scheme proposed by Wall Street that effectively eviscerates the state Access to Public Records Act, today fosters potential pilfering from the pension and lawlessness—such as charging bogus fees, tax

fraud, insider trading, front-running and engaging in self-dealing.

Wrongdoers are not held accountable, rather are shielded from public scrutiny.

Whether the new Treasurer, Seth Magaziner, will perpetuate the secrecy scheme established under Raimondo or, as he has promised, provide greater transparency to the public remains to be seen.

Despite his recent launch of a “transparency initiative” supposedly “unprecedented in Rhode Island and nationally” and his claim that “Rhode Island now has the most transparent state treasury in the country,” Magaziner’s actions to date are not promising.

It seems nothing has changed.

ERSRI’s alternative investments remain shrouded in secrecy and, as discussed further below, Magaziner has approved new fund of fund investments that pay even higher—multiple layers of fees—to Wall Street.

- **Secrecy Prevails As Magaziner Denies Public Access to ERSRI Records**

A few months after taking office, the new Treasurer refused to release to the media uncensored due diligence reports on more than a dozen hedge funds in which the state pension fund had invested.

ERSRI responded to our initial request for public access to information by demanding prepayment of fees in the amount of \$7,626.25.⁵

ERSRI further warned that payment of this (in our opinion, egregious) amount would not guarantee that the records would be provided un-redacted but only “authorizes this office to conduct a search and retrieval to determine if responsive documents exist.”

Tellingly, the letter we received indicated that ERSRI does not maintain **any** documents related to any open investigation of violations of law involving the pension’s money managers.

This response suggests that ERSRI is not only unwilling to grant public access to information involving its highest-risk asset

⁵ (Ironically, as pointed out by Rhode Island WPRO radio talk show host and former two-time Providence Mayor, Buddy Cianci, the amount the Treasurer required for public access to the records exceeded his 2014 personal total income.)

managers but is **unaware of any allegations of wrongdoing involving any of these firms.**

Throughout this investigation, no Rhode Island public official we interviewed indicated any awareness of the very substantial and growing body of evidence related to alternative industry abuses.

How ERSRI can possibly effectively monitor 150 high-regulatory risk investment funds (and dozens more fund of fund underlying funds) without maintaining **any** documents related to actual or potential violations of law is puzzling.⁶

For now, it appears the new Treasurer—like his predecessor—is more interested in shielding Wall Street from public scrutiny than protecting public retirement assets from Wall Street.

As detailed throughout this report, we were able to obtain sufficient information about ERSRI—without the Treasurer’s assistance—to conclude that the pension has squandered billions in recent years and continues to be grossly mismanaged; is exposed to voluminous potential violations of law; lacks appropriate safeguards regarding its alternative investments; and continues to significantly underreport the fees it pays to Wall Street.

⁶ Searching for copies of communications with the SEC alone would consume 239 staff hours and cost \$3,585, ERSRI told us.

- **Red Flags Abound Related to Alternative Investments**

While we cannot know for certain the extent of wrongdoing by any of ERSRI’s money managers—due to Rhode Island’s secrecy scheme and denial of our public records request—we have identified in this report voluminous potential abuses and violations of law based upon the most-current publicly-available information.

Clearly, even the public records reveal substantial “red flags” related to alternative investments.

It is also abundantly clear that Wall Street alternative managers demanding secrecy have caused preventable pension losses.

- **Hedge Funds Cost \$410 Million in Underperformance**

Underperformance related to ERSRI’s **hedge fund** investments has cost the pension **\$410 million**. We note that criticism of public pension hedge fund investing nationally is growing following the decision by CalPERS—the nation’s largest public pension—to very publicly abandon hedge funds due to complexity and transparency concerns amid long-term weak performance.

In light of the many problematic hedge fund practices identified in this report involving billions in retirement assets

nationally, such as unknown hedge fund insiders (who may be politically influential) secretly profiting at the expense of public pensions across the country, it is recommended that this follow-up report (like our 2013 findings) be provided to securities regulators and law enforcement for appropriate action.

- **Private Equity Cost \$854 million in Underperformance**

We estimate **\$854 million** in underperformance related to ERSRI's **private equity** investments. As detailed in our report, the staff of the U.S. Securities and Exchange Commission has recently publicly released its finding of pervasive abuses involving **half** of all private equity firms examined, including charging "bogus" fees and other illegalities. Further, private equity whistleblowers are increasingly coming forward credibly alleging widespread industry wrongdoing.

In light of the pervasive private equity industry abuses identified in this report involving billions in retirement assets nationally, such as illegal fees and tax frauds, it is recommended that this report be provided to the Internal Revenue Service, as well as securities regulators and law enforcement for appropriate action.

- **Private Equity Fees As High As \$86 Million—Not \$18 Million Disclosed**

A leader in investment expense benchmarking recently announced that public pensions have been **massively underreporting** the private equity fees they pay.

We estimate ERSRI's total private equity fees to be as high as **\$86 million** annually—not the \$18 million disclosed. If true, private equity fees **alone** are greater than the total **\$74 million** in direct and indirect investment expenses ERSRI currently discloses **for the entire pension**.

- **\$30 Million Paid to Private Equity Firms For Doing Nothing**

Worse still, ERSRI pays fees of approximately **\$30 million** annually on \$773 million in capital committed to private equity that has yet to even be invested—**\$30 million in private equity fees to Wall Street for doing nothing**.

- **Horrific Real Estate Cost \$638 Million in Underperformance**

Real estate is ERSRI's worst performing asset class by far.

ERSRI's real estate investment performance has been nothing short of **horrific** over the past 10 years—2 percent versus the Fund's benchmark return of 9.6 percent. Real estate

underperformance has cost ERSRI approximately **\$638 million** over the past decade.

- **Real Estate Fees Estimated at \$21.6 Million—Not \$2.7 Million Disclosed**

Total real estate fees are estimated at **\$21.6 million**, not \$2.7 million as disclosed by ERSRI.

More disturbing, given ERSRI's low real estate investment return, on the one hand, and high real estate investment expenses, on the other, it appears that **ERSRI's real estate managers earned more in fees over the past decade than the pension earned in return.**

The causes of ERSRI's dramatic real estate underperformance should be investigated further, in our opinion. Stakeholders deserve an explanation and those responsible should be held accountable.

- **Multiple Layers of Fees in New Fund of Funds**

We identified **multiple layers of substantial fees** in new **fund of funds** in which the pension recently invested.

Fund of funds are highly problematic for numerous reasons including, multiple layers of excessive fees; questionable due diligence and monitoring; duplication of underlying managers where direct investments or multiple fund of funds are involved; and rampant conflicts of interest.

Fund of funds also lack transparency and generally do not disclose the identity of the dozens of underlying funds in which they invest to the public. This opacity can be especially problematic for public funds susceptible to “politicization” of the investment process.

For example, whether ERSRI’s venture funds of funds invest in any Point Judith Capital funds—funds Governor Raimondo used to manage and in which she personally invested—is unknown.

Total asset management, operating fees and expenses related to ERSRI’s new fund of funds investments may amount to **6 percent** or more annually.

In our opinion, due to the multiple layers of substantial fees related to fund of funds, the likelihood that such investments will deliver competitive net investment performance is remote.

Unless the new Treasurer demonstrates greater regard for ERSRI’s investment expenses than the old Treasurer, adding fund of funds to the pension portfolio will only ensure fees paid to Wall Street continue to grow.

- **ERSRI Total Fees Estimated to Range From \$109 million to \$161 Million—Not \$74.6 Million Disclosed**

We estimate total ERSRI 2014 **additional undisclosed** fees may be as much as **\$87 million**. That is, undisclosed fees may be greater than the \$74.6 million in fees **disclosed**.

Thus, it appears that ERSRI's **total fees** (disclosed plus estimated undisclosed)—as we predicted in our earlier report—are already well over \$100 million, i.e., range from a low of **\$109 million** to as high as **\$161 million**.

- **ERSRI and Auditor General Lack Knowledge and Diligence in Overseeing Alternative Investments**

Our investigation concludes, based upon interviews, that neither the Treasurer's Office nor the Office of the State Auditor is knowledgeable about (or aware of) alternative investment costs and abuses, has been effectively monitoring ERSRI's alternative funds, or is even capable of doing so.

- **2016 Final Accounting of ERSRI's Point Judith Investment**

Lastly, we observe that a final accounting of the true performance of ERSRI's \$5 million investment in Point Judith II - a venture fund Raimondo formerly managed (as well as sold

to ERSRI) in which the pension invested on less favorable terms than Raimondo—should be forthcoming in 2016.

As detailed in our prior report, the former Treasurer made numerous public statements regarding the performance of the Point Judith fund, as well as released summary performance figures which were strikingly divergent.

In the event that there has been any misrepresentation of past performance by the former Treasurer, her staff or others, the matter should be referred to the SEC.

II. Introduction

On April 29, 2015, a campaign created by Benchmark Financial Services, Inc., to raise funds over the internet⁷ through “crowdfunding” for a follow-up forensic investigation of the Employees’ Retirement System of the State of Rhode Island was successfully completed.⁸

349 backers pledged \$20,464 to bring this project to life—America’s first forensic investigation of a retirement plan funded by participants and stakeholders.

Today participants in the nation’s retirement plans and other stakeholders (such as taxpayers) pay the cost of the experts employer-plan sponsors hire for advice regarding retirement plan matters,⁹ yet they lack access to experts of their own choosing to review the decisions that are made. Without the information and specialized knowledge to evaluate the plans employers offer, participants and other stakeholders lack an effective voice in plan matters.

⁷ <https://www.kickstarter.com/projects/1525282896/rhode-island-state-pension-forensic-investigation>

⁸ This investigation is a follow-up of our Forensic Investigation of the Employee Retirement System of Rhode Island for Rhode Island Council 94, American Federation of State, County and Municipal Employees, dated October 17, 2013, entitled, Rhode Island Public Pension Reform: Wall Street’s License to Steal.

⁹ For example, in 2014, ERSRI paid approximately \$1 million for investment consulting and legal advice—most of which is not available to the stakeholders who paid for it.

A retirement planning paradigm which specifically excludes the very individuals whose money is at risk makes no sense. While few stakeholders can afford to hire nationally-recognized investment experts on their own, through crowdfunding stakeholder dollars can be combined to fund a high-impact independent expert review at a low cost—far lower than an employer would pay.

In this follow-up investigation, Benchmark has focused upon: (1) the secrecy scheme related to ERSRI investments initiated under former Treasurer Raimondo and continuing under new Treasurer Magaziner; (2) Attorney General Kilmartin’s pro-Wall Street finding in a challenge brought by The Providence Journal to ERSRI’s secrecy scheme and his lack of receptivity to information regarding potential violations of law by ERSRI asset managers; (3) the 40 percent—not 25 percent disclosed—of ERSRI’s assets that have been allocated to 150 high-risk, high-cost alternative investments; (4) growing criticism of public pension hedge fund investing nationally, including the decision by CalPERS—the nation’s largest public pension—to abandon hedge funds; (5) \$410 million in underperformance related to ERSRI’s hedge fund investments; (6) recent SEC findings regarding pervasive wrongdoing involving half of all private equity firms examined, including charging “bogus” fees and other illegalities, as well as credible alternative industry whistleblower claims; (7) \$854 million in underperformance related to ERSRI’s private equity investments; (8) total private

equity fees estimated to be as high as \$86 million annually, not \$18 million as disclosed by ERSRI; (9) fees of approximately \$30 million paid annually on capital committed to private equity that has yet to even be invested; (10) \$638 million in underperformance related to ERSRI's horrific real estate investments; (11) total real estate fees estimated at \$21.6 million, not \$2.7 million as disclosed by ERSRI; (12) multiple layers of significant fees amounting to an estimated 6 percent annually in new funds of funds ERSRI will have to pay going forward; (13) ERSRI's estimated total fees range from \$109 million to \$161 million—not \$74.6 Million disclosed; (14) ERSRI and the Auditor General's lack of knowledge and diligence in overseeing the pension's 150 alternative investments; and, finally, (15) whether 2016 will result in a final accounting and an end to the confusion regarding performance claims relating to ERSRI's \$5 million investment in the Point Judith II venture fund sold to the pension by the former Treasurer.

III. New Treasurer Magaziner Promises Greater Transparency

On January 6, 2015, Seth Magaziner, age 31, assumed office as General Treasurer of Rhode Island with responsibility for overseeing the state's entire \$8 billion in pension assets. The son of President Bill Clinton policy adviser and wealthy Rhode Island business consultant, Ira Magaziner, Treasurer Magaziner had severely limited experience in investment management—

other than a summer internship at Point Judith Capital (a small venture capital firm the former Treasurer founded) and two years as a portfolio associate, then research analyst at Trillium Asset Management in Boston.

Financial disclosures filed with the state Ethics Commission showed that Magaziner, while a candidate for treasurer, earned between \$50,001 and \$100,000 in 2013, had no investments, trusts or other sources of income, yet managed to loan his campaign \$550,000.

“Where did someone making that income have that kind of money to loan his campaign?” asked his opponents and the Providence Journal.¹⁰

By way of background, in 2011, Rhode Island's pension fell victim to a Wall Street coup when Magaziner's predecessor, Gina Raimondo, a venture capital manager with an uncertain investment track record of only a few years—a principal in a firm that had been hired by the state to manage a paltry \$5 million in pension assets—got herself elected Treasurer with the financial backing of out-of-state hedge fund managers.

Transparency and accountability suffered as the pension under Raimondo increased its investments in hedge, venture capital

¹⁰For 2014, Magaziner reported no real estate holdings and no income beyond the proceeds from his sale of employee stock at Trillium and dividends and proceeds from the sale of his holdings in Scottrade Mutual Funds. He disclosed total income of \$5,183, consisting of interest and capital gains. Magaziner paid no state or federal income taxes that year. Asked how he paid his day-to-day expenses, his spokeswoman, Shana Autiello, said: savings and the proceeds from the sale of mutual funds. <http://www.providencejournal.com/article/20150419/NEWS/150419237/0/SEARCH>

and private equity funds from zero to almost \$2 billion or 25 percent (40 percent based upon total commitments) and the former Treasurer withheld virtually all information about these high-risk, high-cost investments from both the general public and the State Investment Commission, a 10-member volunteer body that is chaired by the Treasurer and oversees the investments of the state pension.

While the former Treasurer publicly stated a commitment to transparency, the information regarding ERSRI provided by her and her office to the public was often both intentionally incomplete and misleading, in our opinion.¹¹

The overwhelming majority of the information we requested from the former Treasurer in connection with our 2013 preliminary investigation was withheld from us in apparent violation of state open records laws, including information regarding ERSRI's investments, such as offering documents, annual reports, and audited financials, as well as cash flow statements and performance appraisals regarding the Point Judith II venture capital fund which the former Treasurer at one time managed, solicited ERSRI to invest \$5 million, and continued to personally invest in; offering documents

¹¹ In 2013, four open-government groups – Common Cause Rhode Island, the state's chapter of the American Civil Liberties Union, the Rhode Island Press Association and the League of Women Voters of Rhode Island voiced legitimate concerns regarding the Treasurer's strategy of withholding hedge fund due diligence records from the Providence Journal. The groups were reacting to an August 3, 2013 Providence Journal story about the state's hedge fund investments. These groups believed that since the due diligence financial reports were paid for with public funds and detailed how the state is investing the public's money, they should have been made public in their entirety; further, they found "troubling" the Treasurer's decision to allow the hedge funds to decide what information to release.

disclosing conflicts of interest, potential violations of law, leverage, illiquidity and valuation risks, performance and asset-based fees, related to the ERSRI's numerous alternative investments, as well as any placement agent intermediaries involved.¹²

Candidate Magaziner, who claimed to be an experienced investment professional, promised "strong returns, lower fees, and greater transparency." In an online video interview he said he, unlike Raimondo, would not have signed contracts with hedge fund managers that shielded their pay from the public.

"I would have demanded a higher level of transparency. And if they were not okay with that I would have walked away."¹³

A few months after taking office, the new Treasurer refused to release to the media uncensored due diligence reports on more than a dozen hedge funds in which the state pension fund had invested, despite his campaign commitment to greater transparency than his predecessor.

"In a letter to GoLocalProv, Magaziner's office said that information considered confidential or trade secrets had been redacted. In a statement, spokeswoman Shana Autiello said that the office was relying

¹² All of the information we requested was readily available and of a financial nature of obvious materiality to participants in the Fund, taxpayers and investors in the state's municipal bonds.

¹³ Hedge funds have become a dirty word, Magaziner said, primarily because of the very high fees managers charge clients. He said the four highest-paid hedge fund managers last year made more money than all the kindergarten teachers in the United States. "What's wrong with us as a country when that is what we are willing to put up with," he said. <http://www.rifuture.org/seth-magaziner-hedge-fund-contracts-should-be-public.html>

on the Attorney General Peter Kilmartin’s decision in 2013 that the state public records law did not require then-Treasurer Raimondo to release uncensored copies of the reports to the Providence Journal.”¹⁴

In short, it appeared that the new Treasurer was not going to be any more transparent than the last Treasurer—at least with respect to hedge fund due diligence reports.

Despite his recent launch of a “transparency initiative” supposedly “unprecedented in Rhode Island and nationally” and his claim that “Rhode Island now has the most transparent state treasury in the country,” Magaziner’s actions to date are not promising.

It seems nothing has changed.

ERSRI’s alternative investments remain shrouded in secrecy and, as discussed further below, Magaziner has approved new fund of fund investments that pay even higher—multiple layers of fees—to Wall Street.

¹⁴ <http://www.golocalprov.com/news/transparency-denied-new-treasurer-censors-hedge-fund-reports>

IV. Our Request for Information from ERSRI Effectively Denied

On May 4, 2015, we filed a request for the following information from ERSRI for the period from January 1, 2009 through today:

Copies of any investment consulting contracts between the fund and any of its investment consultants, including but not limited to, Cliffwater LLC and PCA; any investment consultant analyses, performance reports, due diligence reports and other information provided to the fund; any analyses of direct and indirect investment management and other investment-related fees; any audits of investment fees by any third party; any documents related to actual or potential violations of law involving any investment manager or other vendor to the fund; any communications or correspondence with the Securities and Exchange Commission related to the fund, or its assets or its investment managers; any investment manager contracts related to the fund; the offering memorandum, subscription agreement and/or investment advisory contract related to each alternative investment (including hedge, real estate, private equity and venture capital funds) in which the fund has invested, including any investment advisory fee waivers or other documents amending or altering the applicable terms and/or fees; comprehensive disclosure of the total fees applicable to each alternative investment, including but not limited to asset-based, performance fees, monitoring fees and operating fees; any documents related to the payment of placement agent fees by the fund or its investment managers.

On May 18, 2015, we participated in a telephone conference with the new Treasurer and others from his Office wherein he

expressed a commitment to transparency, solicited our suggestions as to how to achieve greater transparency and indicated discomfort regarding the secrecy agreements entered into by the former Treasurer with Wall Street.

The suggestions we provided to the Treasurer included:

- adopt a full transparency policy for all incumbent and future managers to follow;
- redeem all liquid alternative investments managed by firms that refuse to provide full transparency; and
- create a public “transparency watch list” for all managers of illiquid funds that refuse to comply with ERSRI’s new transparency policy.

In our opinion, if threatened with loss of assets (or, at a minimum, potential public backlash), the majority of managers would agree to full transparency.

As we reminded Magaziner, the former Treasurer had adopted a placement agent policy that ERSRI’s managers apparently readily complied with. We encouraged the new Treasurer to take a national leadership role in demanding full transparency with respect to public pensions—a suggestion which he seemed willing to entertain.

To our surprise, later that same day ERSRI responded to our initial request for public access to information by demanding prepayment in the amount of \$7,626.25 for the material investment information we initially requested.

As noted in ERSRI’s response, payment of this (in our opinion, egregious) amount would not guarantee that the records would be provided un-redacted but only “authorizes this office to conduct a search and retrieval to determine if responsive documents exist.”

Tellingly, the letter indicated that ERSRI does not maintain **any** documents related to any open investigation of violations of law and that our term “potential violations” could theoretically apply to any document.

In short, it was apparent that the Treasurer was not going to be forthcoming regarding actual or potential violations of law related to any of ERSRI’s 150 alternative investments—despite the fact that many of these managers are involved in publicly-acknowledged inquiries and controversies.

ERSRI’s response suggests that the fund is not only unwilling to grant public access to information involving its highest-risk asset managers but is **unaware of any allegations of wrongdoing involving these firms.**

Throughout this investigation, no Rhode Island public official we interviewed indicated any awareness of the very substantial and growing body of evidence related to alternative industry abuses.

How ERSRI can possibly effectively monitor 150 high-regulatory risk investment funds (and dozens more fund of fund underlying funds) without maintaining **any** documents related to actual or potential violations of law is puzzling.

Clearly, many ERSRI managers are involved in actual or potential violations of law.

Searching for copies of communications with the SEC alone would consume 239 staff hours and cost \$3,585, ERSRI responded.

In our opinion, to pay \$7,626 to ERSRI for a search that may turn up no, or heavily redacted, relevant documents—would be pointless.

It appears that both the new and former Treasurer are more interested in shielding Wall Street from public scrutiny than protecting public retirement assets from Wall Street.

As detailed throughout this report, we have obtained sufficient additional information about ERSRI—without the Treasurer’s assistance—to conclude that the pension has squandered billions in recent years and continues to be grossly mismanaged; is exposed to voluminous potential violations of law; lacks appropriate safeguards regarding its alternative investments; and continues to significantly underreport the fees it pays to Wall Street.

Finally, we note that Rhode Island’s Access to Public Records Act (“ARPA”) simply represents the minimum amount of

disclosure and a public body may always release documents in its discretion that are exempt from public disclosure, as well as waive search fees in the public interest.

For the protection of stakeholders, the Treasurer should seek to provide maximum, not bare minimum, transparency and accountability.

V. Attorney General Kilmartin’s Pro-Wall Street Finding: Providence Journal v. Rhode Island Office of the General Treasurer

As mentioned above, in July 2014, Rhode Island Attorney General Peter F. Kilmartin responded in a 22-page letter to an Access to Public Records Act (“ARPA”) complaint filed by The Providence Journal against the Office of the General Treasurer by acknowledging that while Rhode Island citizens had an interest in knowing how pension investments made by the State Investment Commission were performing and what those investments cost, such information was already in the public domain (supposedly on the Treasury’s website¹⁵) and that the hedge fund due diligence reports the Journal sought—reports containing information and analysis related to the funds **prior** to Rhode Island’s investments in the funds—contained none of the information the Journal described as vital to the public interest.

¹⁵ As discussed elsewhere, even today it is not accurate to say that all of the information about how these investments have performed and the associated costs are already publicly available.

In a response to our email to Kilmartin’s office regarding the letter, a spokesperson for the Attorney General stated “It was a finding, not an advisory opinion, and it didn’t deny access to records regarding the state’s alternative investments, but instead concerned due diligence reports that were created before the state invested in a particular hedge fund. As I recall, we made clear that the issue was documents created before the state’s investment and not documents relating to the state’s performance or return on investment.”¹⁶

In our opinion, the distinction the Attorney General made between investment-related documents created before an investment by the state and other documents is absurd. The Attorney General should enforce the state’s public records laws to maximize protection to pension stakeholders, not Wall Street. Documents created before the state’s investment may reveal conflicts of interest, lack of proper due diligence and wrongdoing—all of which are of interest to stakeholders.

In a final email to the Attorney General’s office I wrote, “Recently the SEC announced that 50 percent of all private equity firms it had inspected are engaged in illegalities. Would

¹⁶ To which we responded, “So clearly then the hedge fund offering documents, which are not part of the Cliffwater consultant due diligence, are subject to public disclosure. Right?”

The Attorney General’s office responded, “The finding was based on the specific information request. If you seek documents from a public body, i.e. the Office of the General Treasurer, then request those documents from that office per their APRA policy. If you believe they failed to provide the documents you requested in violation of APRA, you can file a complaint with this office, or take the alternative route which would be to file a lawsuit in Superior Court citing the public body in violation.”

the AG want to talk to me about his views as to public access to information relating to which of the 72 private equity firms handling ERSRI's assets may be engaged in wrongdoing?"¹⁷

Remarkably, the Attorney General—the top legal official in Rhode Island—had no interest in discussing with a nationally-recognized expert in pension forensics whether the state pension was at risk of losing billions to Wall Street malfeasance identified by the SEC and investigated routinely by said expert.

VI. 40 Percent—Not 25 Percent—of ERSRI's Assets In 150 Alternative Investments

According to the Composite Reporting Investment Valuation of ERSRI as of March 31, 2015, approximately \$2.08 billion of the Fund's \$8.03 billion in assets, or approximately 25 percent, were invested in alternative investments, including equity hedge funds; private equity; real estate and real return hedge funds.

While the total number of alternative investments is not disclosed, we estimate ERSRI invests directly in at least 104 different alternative investments.

Since ERSRI has begun investing in fund of funds each of which, in turn, invest in dozens of underlying funds, we estimate the

¹⁷ May 8, 2015.

number of the pension's direct and indirect alternative investments is skyrocketing toward 150.¹⁸

- Approximately \$1.153 billion is invested in 21 hedge funds.
- Approximately \$530 million is invested in 72 private equity funds.
- Approximately \$380 million is invested in 11 real estate funds.

It appears that certain other investments, such as inflation linked bonds and publicly traded infrastructure (totaling an addition \$371 million) are also (as limited partnerships) properly classified as alternative investments. If so, ERSRI's alternative assets grow to approximately 30 percent.

However, ERSRI's true exposure to alternatives is far greater.

While the Composite Reporting Investment Valuation indicates \$530,613,119 had been invested in private equity funds at March 31, 2015, an additional **\$773,120,242** had been **committed** to private equity, bringing the private equity total to a staggering **\$1,303,733,361**.

While the Composite Reporting Investment Valuation indicates that ERSRI has \$380 million invested real estate, an additional

¹⁸ It appears that ERSRI has at least \$40 million invested in two funds of funds.

\$105 million has been **committed** to real estate, bringing the real estate total to **\$432 million**.

In conclusion, we estimate almost **40 percent**—not 25 percent—of ERSRI’s assets are exposed to the costs and risks related to alternative investments.¹⁹

VII. \$1.4 Billion Underperformance In Four Short Years – Additional Losses Foreseen

In the four years since ERSRI ramped up its investments in hedge funds, private equity and venture capital, overall pension performance has languished — costing the pension dearly and benefiting only Wall Street.

Based upon ERSRI’s investment track record, it is **highly likely**, continuing to gamble on high-cost, high-risk alternative investments—funds that have consistently underperformed—will result in **billions greater underperformance** over time.

While Wall Street is certain to emerge as a winner under ERSRI’s strategic investment plan, the stakeholders will, in our opinion, lose ever greater amounts due to stratospheric fees and dismal net investment performance.

¹⁹ Note that the SIC’s adopted asset allocation policy targets as of June 30, 2014, indicated 44% targeted to alternatives.

Based upon four years' worth of state financial records, an analysis by International Business Times in August 2014 concluded that ERSRI had delivered an average 12 percent return during the former Treasurer's tenure.

"That rate of return significantly trails the median rate of return for pension systems of similar size across the country, based on data provided to the International Business Times by the Wilshire Trust Universe Comparison Service. Meanwhile, the pension investment strategy that Raimondo began putting in place in 2011 has delivered big fees to Wall Street firms. The one-two punch of below-median returns and higher fees has cost Rhode Island taxpayers hundreds of millions of dollars, according to pension analysts... However, according to pension consultant Chris Tobe, the gap between Rhode Island and the median, a gap to which the (high) fees (associated with alternative investments) contributed, means the state effectively lost \$372 million in unrealized returns.

By way of comparison, \$372 million represents more than one-half of the entire annual budget of the state's largest city, Providence. In all, had Rhode Island's pension system merely performed at the median for pension systems of similar size, the state would have 5 percent more assets in its \$7.5 billion retirement system. Tobe, a former public pension trustee in Kentucky and the author of the book "Kentucky Fried Pensions," said this difference between Rhode Island and the median can be directly linked to the high fees of the state's alternative investments, which he said drags the system's performance below that of traditional public equities."²⁰

²⁰ <http://www.ibtimes.com/rhode-island-has-lost-372-million-state-shifted-pension-cash-wall-street-1671790>

Given that virtually all public pensions of similar size imprudently allocated significant assets to alternative investments (due to politicization), a more appropriate analysis of avoidable losses would be comparison against a benchmark consisting of 80 percent stocks (S&P 500) and 20 percent bonds (Barclays U.S. Aggregate). This analysis reveals **\$1.44 billion** in ERSRI underperformance through FY 2014, according to consultant Tobe.

Even compared against a benchmark consisting 75 percent stocks (S&P 500) and 25 percent bonds (Barclays U.S. Aggregate), reveals **\$1.2 billion** in underperformance, says Tobe.

In other words, during the former Treasurer's four-year tenure, gambling in alternative investments cost ERSRI stakeholders almost **\$1 million a day**.

VIII. Hedge Funds

A. Growing Criticism of Public Pension Hedge Fund Investing

As we noted in our prior report, possibly the world's greatest investor, the Oracle of Omaha, Warren Buffett, seven years ago wagered \$1 million that hedge funds would not beat the S&P

500 over the next ten years. At this point, “it’s looking like a rout for the CEO of Berkshire Hathaway.”²¹

Buffet also has criticized the compensation structure of hedge funds, which often pay themselves an administrative fee of 2 percent of assets whether they make money or lose it, and 20 percent of annual profits. He has said the “2 and 20” structure offers pay for nonperformance.²²

For example, 8 of ERSRI’s 21 hedge fund managers, or 38 percent, received asset-based fees but zero or limited performance fees in FY 2014—despite strong stock market performance.

John Bogle, Founder of the Vanguard Group, warned in June, 2013, that “hedge funds are hardly a panacea.” The downside protection that hedge funds provide is illusory, said Bogle.²³

More recently, in September, 2014, the California Public Employees' Retirement System announced it would shed its entire \$4 billion investment in hedge funds over the next year

²¹ Under the terms of the wager, Buffett is betting on the stock market performance of an S&P 500 index fund while Protégé Partners, a New York money manager, is banking on five funds of hedge funds that Protégé carefully picked at the outset. Through the seven years, Vanguard’s 500 index fund, as represented by its Admiral shares, is up **63.5%**. Protégé’s five hedge funds of funds are, on the average up an estimated 19.6%. <http://fortune.com/2015/02/03/berkshires-buffett-adds-to-his-lead-in-1-million-bet-with-hedge-fund/>

²² Buffett Receives Rare Chewing Out, Wall Street Journal, May 8, 2015.

²³ Wall Street Journal, Letters to the Editor, June 5, 2013.

as part of an effort to simplify its assets and reduce costs. This retreat by the nation's largest public fund has prompted other cities and states to consider similar moves.

The funds that manage money for Calpers include Och-Ziff Capital Management Group, which had more than \$700 million of the roughly \$4 billion (and which also has managed approximately \$100 million for ERSRI since 2011).

While Calpers stated that the decision wasn't based on the performance of the program, the hedge funds earned 7.1% during a fiscal year when all of Calpers returned 18.4%.²⁴

The annualized rate of return on its hedge fund investments over the last 10 years was 4.8 percent.²⁵

When a trustee of the San Francisco City & County Employees Retirement System asked Warren Buffett in 2014 whether to invest in hedge funds, Buffett's response was terse and clear. "I would not go with hedge funds — would prefer index funds."²⁶

A May 2015 Report to the Utah Legislature by the Office of the Legislative Auditor General concluded that if the Utah pension

²⁴ <http://www.wsj.com/articles/calpers-to-exit-hedge-funds-1410821083>

²⁵ <http://www.bloomberg.com/news/articles/2014-09-15/calpers-to-exit-hedge-funds-citing-expenses-complexity>

²⁶ <http://pando.com/2014/06/17/warren-buffetts-warning-to-sf-spotlights-the-dangers-of-wall-streets-alternative-investment-schemes/>

had fewer alternatives and avoided hedge funds, it would have gained \$1.35 billion in additional assets by 2013. The consultant recommended that Utah reduce its allocation to alternatives, primarily by reducing the allocation to hedge funds. The Report noted that the pension investment costs were higher than similar retirement systems because of its expensive alternative investments strategy.²⁷

B. Hedge Funds Cost \$410 Million in Underperformance

The April 30, 2015 Total Performance Summary Net of Fees indicates equity hedge fund 3-year annualized performance of 8.83 percent. The annualized return of the Russell 3000 amounted to 16.9 percent—almost twice the hedge fund rate of return with substantially lower risk and fees.

In other words, the \$617 million ERSRI invested in equity hedge funds underperformed in the amount of **\$189 million** over the three years.

While the equity hedge funds performed dismally, the \$550 million invested in real return hedge funds did even worse—6.1 percent, costing ERSRI **\$221 million** in underperformance over the three years.

²⁷ A Performance Audit of URS' Management and Investment Practices, http://le.utah.gov/audit/15_03rpt.pdf

In total, over the 3-year period the hedge fund program cost the pension **\$410 million** in underperformance.

C. Specific Hedge Fund Concerns

In our previous report we noted that, contrary to representations by the former Treasurer, ERSRI's hedge fund investments are:

- High-risk, speculative investments;
- High-cost, involving myriad asset-based, performance and other fees and expenses;
- Illiquid, lacking a public market;
- Largely unconstrained and may change investment strategies at any time;
- Permitted to generally use unlimited leverage;
- Provide no assurance of diversification;
- Lack comprehensive regulation in the U.S.;
- Subject to heightened offshore legal, regulatory, operational and custody risk;
- Subject to myriad, profound conflicts of interest involving self-dealing; and
- Engage in practices that, **with respect to ERSRI**, may violate applicable law.

That is, certain practices in which ERSRI's hedge fund managers engage may be acceptable to high net worth individuals (or unknown to them) but violate laws applicable to pensions generally and ERSRI specifically.

For example, many of ERSRI’s hedge fund managers indicate that they may withhold information regarding fund investments from ERSRI and provide such information, as well as grant more favorable rights, to certain hedge fund insiders—insiders whose identities will not be disclosed.

In our opinion, such practices which permit unknown parties to profit at the expense of the state pension amount to a “license to steal” from the state pension and may violate state law.

As we stated in our previous report:

“In summary, the hedge fund offering documents appallingly reveal that investors, such as ERSRI, agree to permit hedge fund managers to withhold complete and timely disclosure of material information regarding ERSRI’s assets in their funds. Further, ERSRI 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 ERSRI.

As a result, ERSRI is at risk that other unknown investors are profiting at its expense—stealing from the pension. Finally, the offering documents warn that the hedge fund nondisclosure policies may violate applicable laws, including, but not limited to Rhode Island’s.

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

Further, the Treasurer has not disclosed to the State Investment Commission and ERSRI has not, in turn, disclosed to participants in the Fund and taxpayers that such outrageous, unfair and potentially illegal

disclosure schemes are common with respect to its alternative investments.

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

In order to assess the risks, potential fiduciary breaches and violations of law related to the 21 hedge funds owned by ERSRI, we once again reviewed private offering materials and SEC filings related to certain of these secretive high-risk, high-cost investments.

- **Och Ziff:** The publicly traded hedge-fund firm disclosed to investors in March 2014 that the SEC and Justice Department were investigating "an investment by a foreign sovereign wealth fund in some of the Och-Ziff funds in 2007 and investments by some of the funds, both directly and indirectly, in a number of companies in Africa."

According to the Wall Street Journal, the Justice Department and Securities and Exchange Commission were investigating whether the firm may have made a payment that constituted a bribe. The U.S. Foreign Corrupt Practices Act bars firms doing business in the U.S. from giving money or items of value to foreign officials

for business. It is unclear whether the government has evidence any of the fee Och-Ziff paid went to any Libyan government officials.

“U.S. investigators probing Och-Ziff Capital Management Group LLC’s dealings in Libya are focused on a multimillion-dollar payment by the big hedge-fund firm they believe was funneled in part to a friend of Col. Moammar Gadhafi’s son, said people briefed on the inquiry. The scrutiny is part of a broad, three-year foreign bribery investigation by the Justice Department and Securities and Exchange Commission into how Wall Street firms obtained investments from the regime of the former dictator, who was deposed and killed in the country’s 2011 revolution. A key part of the Och-Ziff investigation relates to a fee that Och-Ziff paid to the company of a London middleman for help winning a \$300 million investment in Och-Ziff funds from the Gadhafi regime, the people briefed on the matter said.”²⁸

- **Ascend Partners:** In 2003, Malcolm P. Fairbairn, founder of Ascend and his wife were ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 10(a) of the Exchange Act and Regulation M, Rule 105.²⁹ On three occasions in 2001, Ascend and the Fairbairns sold securities short during the five business days before the pricing of public offerings

²⁸ <http://www.wsj.com/articles/u-s-probes-och-ziff-fee-paid-in-libyan-dealings-1417736545?mod=mktw>

²⁹ Rule 105 of Regulation M, "Short Selling in Connection With a Public Offering," prohibits covering a short sale with securities obtained in a public offering if the short sale occurred within five business days before the pricing of the offering (the "pricing period").

and then covered the short positions with securities purchased in the offerings, in violation of law.

Their profits on these transactions totaled \$19,033.50. They were ordered to pay disgorgement and prejudgment interest in the total amount of \$21,258.50 to the United States Treasury. They were further ordered to pay a civil money penalty in the amount of \$25,000.00.³⁰

Annual performance of the Ascend fund in which ERSRI invested as of December 31, 2014 appears to be a mere 4.99 percent—in a year when the S&P 500 returned 13.6 percent.

- **Mason Capital:** Mason Capital lost 12 percent in 2014 (versus a 13.6 percent positive return for the S&P 500), posting a decline so steep that one of its top-tier pension fund clients has already terminated the hedge fund, reported Reuters.

“The state of Rhode Island asked the New York-based firm to return the \$60 million it had been investing for its pension fund since 2012, spokesman Andrew Roos told Reuters.

An official for the firm declined to comment, but a source who requested anonymity because the hedge fund is private said returns were down 12 percent last year.

³⁰ <https://www.sec.gov/litigation/admin/34-48188.htm>

Rhode Island's decision in November to fire Mason Capital, which has not previously been reported, could create fresh problems for Mason Capital. While the state's investment is relatively small for the \$9 billion fund, hedge fund managers do not like losing pension funds as clients because their departure could cast a shadow over a firm's overall attractiveness.

...Rhode Island's Investment Commission, which usually holds public meetings, moved into a closed session and sealed the minutes of its deliberations.

2014 has been a tough year for many hedge funds with the average fund gaining only 3.57 percent, far less than the Standard & Poor's 500 13.6 percent gain.

For Rhode Island, Mason Capital was the pension fund's first pension fund investments but also one of its worst-performing global equity hedge bets according data for the last five years.”³¹

- **Winton Futures Fund:** In April 2015, Winton’s Futures fund suffered its largest monthly loss since July 2008, dropping 4.1%, in part due to losing euro and energy bets, the firm told investors. Said the Wall Street Journal:

“Hedge funds on average have trailed the S&P 500 since 2009—a not-unexpected circumstance given the bull market but to a degree that has caused some investors to question the value of active management.”³²

³¹ <http://www.reuters.com/article/2015/01/13/us-masoncapital-idUSKBN0KL25D20150113>

³² <http://www.wsj.com/articles/market-u-turn-rams-hedge-funds-1430870382>

- **Brevan Howard:** In *Brevan Howard's Assets Said to Shrink by \$9 Billion in 3 Months*, Bloomberg reported “Brevan Howard Asset Management shed a quarter of its assets in three months after the hedge-fund firm posted its first losing year and an affiliated manager took control of two investment pools.”

Also, said Bloomberg:

“Brevan and one of its nearest European rivals, BlueCrest Capital Management, have seen their macro funds under-perform other funds running a similar strategy. Global macro hedge funds returned 6.4 percent on average last year, according to data from Chicago-based Hedge Fund Research.

The Brevan Howard Master Fund, which bets on macro-economic trends and accounts for most of the firm's assets, fell 0.8 percent for 2014 after slipping 0.15 percent in December, a person with knowledge of the performance said this week.

The Financial Times reported last year that the London Pension Fund Authority had asked to withdraw its investment in Brevan's hedge funds. Swiss Re AG is looking to sell its 15 percent stake in the firm...”³³

- **Elliot Associates:** According to Reuters, Elliott Associates returned 12.4 percent in 2013—in a year when the S&P

³³ <http://www.bloomberg.com/news/articles/2015-01-09/brevan-howard-s-assets-said-to-shrink-by-9-billion-in-3-months>

500 rose almost 30 percent.³⁴ During the past five years, Elliott gained between 8 percent and 9 percent annualized, depending on the fund. That's below the S&P 500, said the New York Post.³⁵

- **BlueCrest Capital:** BlueCrest posted a 0.15 percent gain in 2014 in its flagship macro fund, according to Bloomberg, again far less than the Standard & Poor's 500 13.6 percent gain.³⁶
- **Luxor Capital Partners:** According to the minutes of the March 25, 2015 SIC, Luxor has been put on ERSRI's "watch list" by alternative investment consultant Cliffwater.
- **Samlyn:** Joy Fox, a spokeswoman for Treasurer Raimondo, told Reuters that \$20 million (taken from hedge fund manager Third Point) going to Samlyn will be invested in a share class that has a 1.5 percent management fee and 17.5 percent performance fee, slightly lower than the traditional fees of 2 percent and 20 percent many funds charge.³⁷

³⁴ <http://www.reuters.com/article/2014/01/07/hedgefunds-elliott-idUSL2N0KH17N20140107>

³⁵ <http://nypost.com/2015/04/12/paul-singers-hedge-fund-takes-a-dip/>

³⁶ <http://www.bloomberg.com/news/articles/2015-01-09/brevan-howard-s-assets-said-to-shrink-by-9-billion-in-3-months>

³⁷ <http://www.reuters.com/article/2014/02/01/hedgefunds-loeb-idUSL2N0L603520140201>

Fox appears to have gotten her facts wrong. ERSRI's investment fee analysis indicates that the firm was paid a 2 percent and 20 percent fee for FY2012 and 2013 and 1.9 percent and 20 percent in 2014. The Reuters article also noted:

"Rhode Island Treasurer Raimondo has also drawn a lot of attention by helping reform the state's public pension system and thanks to her bid to run for governor.

But she has also been criticized for putting as much as \$1.15 billion into hedge funds at a time when they are costly and have not outperformed the market. Last year the average fund gained 9.3 percent while the Standard & Poor's 500 Index climbed 32.4 percent."³⁸

Viking Global Equities: The Confidential Offering Memorandum related to this fund is hardly secret—it's available online.³⁹

According to Bloomberg, in 2014 the firm gained 12 percent in its main hedge fund, less than the Standard & Poor's 500 13.6 percent gain.⁴⁰

³⁸ <http://www.reuters.com/article/2014/02/01/hedgefunds-loeb-idUSL2N0L603520140201>

³⁹ <https://s3.amazonaws.com/s3.documentcloud.org/documents/407978/viking-global-equities-lp-confidential.pdf>

⁴⁰ <http://www.bloomberg.com/news/articles/2014-11-17/viking-said-to-gain-12-in-2014-with-health-care-alibaba-1->

IX. Private Equity

A. Private Equity Secrecy

Prior to the past decade, public access to investment management agreements and other documents between public pensions, their investment managers and other vendors was routinely granted. The notion that these documents contained “trade secrets” or “confidential business information” the disclosure of which would be harmful to a manager (and therefore, the documents should be kept secret) would have been unthinkable. “Public access” meant the public had a right to know how public funds were being invested.

If an investment manager wanted to manage public pension assets, he knew he would have to submit to public scrutiny.

The private equity industry today (like hedge funds) profits by operating in secrecy—unprecedented secrecy it has fought hard to establish state-by-state. The industry has argued that information and documents which are publicly available, e.g. through the SEC’s IARD database, as well as thousands of copies of which are disseminated to potential investors and financial intermediaries, are exempt from disclosure under state access to public records laws.

In 2014, Naked Capitalism published online twelve private equity limited partnership agreements it had obtained through the Pennsylvania Treasury E-Contracts Library.

The publication noted:

“It is almost certain that no one, certainly no one associated with the private equity industry, was aware that the Pennsylvania Treasury Department made these documents public, since as you can see, the agreements themselves contain stringent confidentiality provisions. Moreover, the private equity industry has been so determined to keep these documents secret that in every state, it either has gotten legislation passed, or had attorney general opinions issued, that exempt private equity limited partnership agreements, along with detailed fee and return information, from state Freedom of Information Act laws. This means that they were the only class of contract that state governments entered into that were shielded from public scrutiny.”⁴¹

Naked Capitalism later added another 13 limited partnerships agreements, bringing the total to 25. The publication stated, “We obtained these contracts from a party authorized to receive them who is not bound by a non-disclosure agreement.”⁴²

As mentioned below, there is mounting evidence of pervasive wrongdoing in the private equity industry—wrongdoing that has flourished due to the secrecy scheme.

It is important to note by agreeing to secrecy, ERSRI facilitates potential wrongdoing by alternative managers related to its assets.

⁴¹ <http://nakedcapitalism.net/documents.html>

⁴² ERSRI does not invest in any of the limited partnerships listed on Naked Capitalism.

Also, in addition to the substantial revelations of private equity wrongdoing mentioned below, there is a substantial body of secretly-reported misdeeds. The overwhelming majority of abuses that have been reported to regulators (including malfeasance regulators are currently prosecuting) have **not** been made public by whistleblowers, aggrieved investors and regulators.

That is, the abuses listed below are the mere “tip of the iceberg.”

B. Private Equity Costs ERSRI \$854 million in Underperformance

Over the past five years, ERSRI’s private equity asset allocation has massively underperformed (10.8 percent annually) compared to even the custom benchmark (15.7 percent) used by the fund.

Note: ERSRI compares its private equity performance against a benchmark index (ILPA All Funds Index) that consists of private equity funds, as opposed to a more appropriate relevant public markets index plus a standard risk premium of, say, 4 percent.

Over the same period, the Russell 3000 had an annualized return of 14.33 percent. Thus, to justify the greater risk related to private equity, ERSRI’s private equity investments should have returned almost 18.33 percent.

Unfortunately, over the past 5 years ERSRI's private equity investment underperformance has amounted to approximately **\$854 million**.

C. SEC Finds Pervasive Private Equity Bogus Fees and Illegalities

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 potentially many of ERSRI's 72 private equity managers) by the agency.

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, you can't afford as a business matter to be deemed to be engaging in fraud. Fraud doesn't sell very well (emphasis added)."⁴³

As mentioned earlier, when we requested documents related to such potential violations of the securities laws from the Treasurer, our request was effectively denied.

Accordingly, in our opinion, whether any of the ERSRI private equity funds have been charging bogus fees to portfolio companies (or engaged in any other form of wrongdoing) 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 by ERSRI of its share of any fees improperly charged.

D. Private Equity Transaction Fees Securities Law Violations

Transaction 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 subject of an SEC whistleblower complaint filed by a senior private equity insider.⁴⁴

⁴³ Bogus Private-Equity Fees Said Found at 200 Firms by SEC, Bloomberg News, April 7, 2014.

⁴⁴ A whistleblower wants to take away private equity's 'crack cocaine,' CNBC, December 5, 2013.

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 ERSRI 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 effectively denied.

Accordingly, in our opinion, whether any of the ERSRI 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 SEC for further investigation, as well as potential recovery to ERSRI of its share of any transaction fees improperly charged.

E. 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.⁴⁵

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.⁴⁶

While we requested information regarding violations of law related to such monitoring fees from the Treasurer, our request was effectively denied.

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

Accordingly, in our opinion, whether any of the portfolio companies owned by 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

⁴⁵ Tax Expert Sees Abuse in a Stream of Private Equity Fees, New York Times Deal Book, February 3, 2014.

⁴⁶ Private-Equity Firms' Fees Get a Closer Look, Wall Street Journal, February 2, 2014.

revenue is a matter that should be referred to the IRS for further investigation.

F. Private Equity Management Fee Waivers Tax Law Violations

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.⁴⁷

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.”⁴⁸

⁴⁷ [IRS Wakes Up to Private Equity Scam](#), Naked Capitalism, October 16, 2013.

⁴⁸ [Los Angeles Public Pension Fund Tells Us It Is a Happy, Trusting Victim of Private Equity Funds](#), Naked Capitalism, March 28, 2014.

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

Accordingly, in our opinion, whether any of the ERSRI's 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.

G. Private Equity Under-Reporting of Fees

According to a recent New York Times article, the rates of return and hidden costs related to private equity are difficult for even investors in these deals, such as ERSRI, to identify.⁴⁹

While certain fees associated with private equity funds are widely known — managers typically charge investors 1 to 2 percent of assets and 20 percent of portfolio gains — other charges, including transaction fees, legal costs, taxes, monitoring or oversight fees, and other expenses charged to the portfolio companies held in a fund are less visible— including unauthorized or bogus fees.

According to a recent report by CEM Benchmarking, a consulting firm that offers pension fund performance analysis,

⁴⁹ http://www.nytimes.com/2015/05/03/business/pension-funds-can-only-guess-at-private-equitys-cost.html?_r=0

more than half of private equity costs charged to pension funds is not being disclosed. The time has come for standardized total cost disclosure for private equity, says CEM.⁵⁰

By way of background, public pensions follow the Governmental Accounting Standards Series issued by GASB. Until recently, all state pension funds were not required to include in the reported amount of investment expense investment-related costs that were not readily separable from investment income or the general administrative expenses of the plan. This standard was ambiguous and permitted widely divergent interpretation of which investment costs were “readily separable.”

In June 2012, GASB issued amended guidelines which stated that if separable (readily, or not) the investment-related costs should be reported as investment expense. The new guidelines still allow very material costs that are netted from returns to be excluded from financial statements. “The amended guidelines have not led to more transparent cost disclosure, especially for private equity,” says CEM.

CEM concluded that the difference between what funds reported as expenses and what they actually charged investors averaged at least two percentage points a year. That is, estimated total direct limited partner costs amounted to **3.82**

⁵⁰ The time has come for standardized total cost disclosure for private equity, CEM Benchmarking, April 2015.

percent annually, not the 1.80% reported by pensions. CEM acknowledged this estimate is probably low. A 2007 academic paper found that the average private equity buyout fund charged more than **7 percent** in fees each year.⁵¹

Based upon our forensic experience, we believe fees approaching **8 percent** annually are commonplace.

H. Private Equity Fees Estimated As High As \$86 Million— Not \$18 Million Disclosed

According to the Treasurer's unaudited ERSRI FY 2014 Private Equity Investment Expense Analysis, the expenses related to approximately \$1.23 billion committed capital amount to approximately \$18 million.

Assuming fees of 3.82 percent annually on \$1.23 billion, the total fees on private equity may amount to far more – approximately **\$47 million** or **\$29 million** more than ERSRI discloses.

Assuming fees of 7 percent annually on \$1.23 billion, the total fees on private equity may amount to as much as **\$86 million** or **\$68 million** more than the pension discloses.

In other words, private equity fees as much as \$86 million **alone** is greater than the total \$74 million in direct and indirect investment expenses ERSRI currently discloses **for the entire pension.**

⁵¹ Beware of Venturing into Private Equity, Journal of Economic Perspectives, Forthcoming, Ludovic Phalippou, 2009.

I. **\$30 Million Paid to Private Equity Firms For Doing Nothing**

According to ERSRI, “private equity management fee terms are commonly structured such that fees are paid based on committed capital during the first 3-5 years of a fund’s life and on the cost basis of invested capital thereafter.

Thus, it appears that ERSRI may pay fees of approximately **\$30 million** annually on committed capital that has yet to even be invested—**\$30 million in private equity fees to Wall Street for doing nothing.**

South Carolina State Treasurer Curtis Loftis made the following plea in the New York Times, “I wish every treasurer would speak up or every investment commission would speak up. Every pension plan in the nation is paying too much, and it’s being hidden.”

Hopefully, Rhode Island’s new Treasurer will take heed and join the effort to expose hidden private equity fees.

J. **Private Equity Potential Fiduciary Breaches and Illegalities**

In order to assess the risks, potential fiduciary breaches and violations of law related to the 72 private equity funds owned by ERSRI, we reviewed SEC filings related and other public records related to 12 of these investments.

- **Fenway Partners:** According to the Wall Street Journal, Fenway Partners was recently warned that U.S. securities regulators may take action against the New York private-equity firm over its disclosure of expenses, fees and other financial information. Fenway told pension funds and other investors in March that the Securities and Exchange Commission had sent it a Wells notice, which the agency uses to alert people and firms that it may take action against them, such as bringing a civil lawsuit.⁵²
- **Riverside Capital Appreciation Fund VI:** A whistleblower complaint was filed with the SEC stating that Riverside Partners admitted in its SEC Form ADV filings that it was charging “costs” to investors that were not permitted by the limited partnership agreement.

According to the reporter who filed the complaint:

“The fact that Riverside hasn’t stopped making impermissible charges, which we view as tantamount to embezzlement, speaks volumes about what it apparently thinks about the vigilance of the SEC and its investors. One has to assume that Riverside’s limited partners either didn’t look at the Form ADV filing at all or gave it such a cursory look that they missed the admission. That is damning in light of Andrew Bowden’s (of the SEC) speech last May warning of widespread abuses in how private equity firms charge fees and expenses. The Riverside text at issue is in a section of the Form ADV called “Fees”; you’d think it would have been a must-

⁵² <http://www.wsj.com/articles/sec-warns-fenway-partners-of-possible-action-1428073087?KEYWORDS=fenway+partners+and+sec>

- review item for limited partners after the Bowden speech. This demonstrates how lax investors have been in taking steps to remedy abuses by private equity general partners, even when they have unambiguous evidence of malfeasance.”⁵³
- **TPG:** Earlier this year TPG disclosed millions in annual additional fees charged to investors (on top of asset management, performance, transaction and monitoring fees), as the SEC has pushed for greater disclosure.⁵⁴
 - **Carlyle:** Carlyle, one of the largest and most politically connected private equity firms, in 2009 agreed to pay \$20 million and make broad changes to its practices to end an inquiry by New York’s state attorney general into its pension business. Under the deal, Carlyle no longer would use intermediaries, known as placement agents, to gain investment business from public pension funds nationwide, and would curtail its campaign contributions to elected officials who oversee pension funds.⁵⁵

According to regulatory filings, Carlyle collected \$245 million in extra fees between 2008 and the end of 2013, compared with \$4.6 billion in carried interest.⁵⁶

⁵³ <http://www.nakedcapitalism.com/2015/04/we-made-an-sec-private-equity-whistleblower-filing.html>

⁵⁴ <http://www.scmp.com/business/banking-finance/article/1673090/blackstone-tpg-capital-disclose-fees-under-pressure-us-sec>

⁵⁵ <http://www.nytimes.com/2009/05/15/nyregion/15carlyle.html>

⁵⁶ <http://www.wsj.com/articles/fees-get-leaner-on-private-equity-1419809350?cb=logged0.46937971841543913>

- **Bain, Carlyle and TPG:** In August 2014, Carlyle settled a lawsuit contending that it and other large buyout firms had colluded to suppress the share prices of companies they were acquiring. The lawsuit targeted some other ERSRI private equity managers, i.e., Bain Capital, and TPG. Carlyle agreed to pay \$115 million in a settlement but didn't pay those costs.

“Instead, investors in Carlyle Partners IV, a \$7.8 billion buyout fund started in 2004, will bear the settlement costs that are not covered by insurance. Those investors include retired state and city employees in California, Illinois, Louisiana, Ohio, Texas and 10 other states. Five New York City and state pensions are among them.”⁵⁷

- **Providence Equity:** It has been a bumpy few years for Providence Equity, said the New York Times in April 2015. In February, one of the firm's biggest investments, the security screener Altegrity, filed for bankruptcy in the face of fraud accusations. Providence had its entire \$800 million stake wiped out, the largest loss in the firm's 26-year history.

In 2011, a former USIS (Altegrity's previous name) manager in Alabama filed a whistle-blower lawsuit that the government later joined asserting that 40 percent, or 665,000, of the investigations USIS turned in

⁵⁷ http://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html?_r=0

to the government between 2008 and 2012 were incomplete.

Altegrity's reputation suffered another blow after revelations that it had performed the background checks on Edward J. Snowden, the former National Security Agency contractor who leaked documents to journalists, and Aaron Alexis, the Washington Navy Yard shooter who killed 12 people in 2013.

The final straw was a hacking attack on USIS, which led the government to withdraw its contracts. With the loss of that business, and buckling under \$1.8 billion in debt, Altegrity filed for bankruptcy protection in February.⁵⁸

Jonathan Nelson, founder of the Providence Equity, was quoted saying:

"We grew too fast. We were managing too much money," Mr. Nelson said. "That was the hallmark of that era, but it doesn't make me less disappointed in our results."

He acknowledged that the firm made too many investments at precisely the wrong time, in 2007 and 2008, just as the private equity boom was cresting. "That was an absolute killer," he said. "If you look at our terrible deals, they were done in that time period."

⁵⁸ http://www.nytimes.com/2015/04/26/business/the-firm-that-grew-too-fast.html?_r=0

As disclosed in the firm’s most recent Form ADV filing with the SEC, certain of the principals and employees of the adviser or their family members may invest in the Providence funds and the management fees assessed on their investments are typically substantially reduced or waived entirely. In addition, all of the principals’ and employees’ capital subscription may be made through reductions in or waiver of the management fee payable to the adviser by such fund in lieu of capital contributions by such principals and employees.

It is further disclosed that the adviser performs management, advisory, monitoring, transaction-related services, financial advisory services and other services for, and receives fees from, actual or prospective portfolio companies. These other fees are often substantial and in addition to management fees paid.

In our opinion, a state pension fiduciary should not agree to permit employees of a richly-compensated asset manager to participate in the same funds in which the pension invests on more favorable terms.

Based upon our forensic experience, it is likely that virtually all of ERSRI’s private equity managers permit their principals, employees and “friends” to participate in their funds on a preferential basis—potentially profiting at the expense of ERSRI.

Further, the adviser causing the portfolio companies to pay it other fees and expenses gives rise to serious conflicts of interest—matters which are of concern to the SEC at this time.

X. Horrific Real Estate Cost \$638 Million in Underperformance

Real estate is ERSRI's worst performing asset class by far.

ERSRI's real estate investment performance has been nothing short of horrific over the past 10 years—2 percent versus the Fund's benchmark return of 9.6 percent.⁵⁹ Real estate underperformance appears to have cost ERSRI approximately **\$638 million** over the past decade.

While the Treasurer's website provides an analysis regarding certain private equity, as well as hedge fund direct and indirect investment expenses, by manager, for whatever reason no such analysis of expenses by manager is provided for the 11 real estate managers.⁶⁰

⁵⁹ According to a study by Cliffwater, ERSRI's investment consultant, the median real estate return for 23 reporting state pensions was 8.2% for the 10-year period ended June 30, 2013.

⁶⁰ We mentioned this lack of disclosure to Treasurer Magaziner in our one telephone conversation cited earlier. He had no explanation for the oversight.

XI. Real Estate Fees Estimated at \$21.6 Million—Not \$2.7 Million Disclosed

The FY 2014 Investment Expense Analysis simply states that the fund paid \$1.5 million in management fees; \$888,000 in indirect management fees; \$297,000 in indirect performance fees, for a total of \$2.7 million in total expenses to the 11 real estate managers. (Given the massive underperformance losses, the fact that managers collectively earned even \$297,000 for so-called “performance” last year is disturbing.)

ERSRI has a total real estate commitment of \$432 million with an unfunded commitment of approximately \$105 million. Thus, the disclosed fees amount to approximately 62 bpts.

Assuming the underlying real estate managers charge asset-based and incentive fees of 2 percent and 20 percent respectively, total asset-based fees (assuming no performance fees) may amount to approximately **\$8.6 million**. That is, the **undisclosed** asset-based fees may amount to approximately **\$6 million** in 2014 alone.

More disturbing, given ERSRI’s low real estate investment return, on the one hand, and high estimated asset-based fees, on the other, it appears **the real estate managers earned more in asset-based and performance fees than the pension earned in returns.**

However, with respect to real estate asset management specifically, there potentially many additional transaction,

development and property management fees that may be charged in addition to the basic annual management fee — additional fees that the Treasurer has not disclosed (and may not even be aware of).

For example, in some real estate funds investors are exposed to double (and sometimes triple) incentive fees, such as when the manager invests fund-level assets in one or more joint ventures.⁶¹

The undisclosed real estate investment-related expenses may amount to an additional **3 percent**, based upon our experience. That is, there may be an additional **\$13 million** in undisclosed real estate expenses, bringing the total fees to **\$21.6 million**.

Even if an allocation of assets to real estate was deemed prudent, there were, and are, far less-expensive, less risky, liquid, publicly-traded options—such as the Vanguard REIT Index Fund (which has a 10-year annualized return of 9.7 percent).

In conclusion, high real estate investment expenses and ERSRI's \$638 million real estate underperformance loss was easily avoidable.

The causes of ERSRI's dramatic real estate underperformance should be investigated further, in our opinion. Stakeholders

⁶¹ <http://faculty.chicagobooth.edu/joseph.pagliari/files/other/FeeStructuresRE.pdf>

deserve an explanation and those responsible should be held accountable.

XII. Multiple Layers of Fees in New Fund of Funds

Earlier this year ERSRI committed up to \$15 million to Industry Ventures Partnership Holdings III-C, a venture capital fund of funds. In June, 2014, ERSRI committed up to \$25 million to Industry Ventures Partnership Holdings III.⁶²

Fund of funds are highly problematic for numerous reasons including, multiple layers of excessive fees; questionable due diligence and monitoring; duplication of underlying managers where direct investments or multiple fund of funds are involved; and rampant conflicts of interest.

Fund of funds also lack transparency and generally do not disclose the identity of the dozens of underlying funds in which they invest to the public. This opacity can be especially problematic for public funds susceptible to “politicization” of the investment process.

For example, whether ERSRI’s venture funds of funds invest in any Point Judith Capital funds—funds Governor Raimondo used to manage and in which she personally invested—is unknown.

⁶² <http://www.pionline.com/article/20150226/ONLINE/150229890/rhode-island-commits-15-million-to-venture-capital-fund-of-funds>

According to the firm's SEC filings, "The annual management fee payable to Industry Ventures by a fund typically is 1% to 1.5% of the capital commitments and typically between 5% and 20% of the Fund's net profits."

There are additional substantial fees (typically 2 percent asset-based and 20 percent incentive) related to the underlying investments:

"Industry Ventures' Funds typically invest in venture capital funds managed by third parties. The managers of such venture capital funds typically receive significant management fees and carried interests from their investors, including Industry Ventures' Funds. As a result, the Limited Partners will be subject to these fees and carried interests, in addition to the management fees and carried interests to Industry Ventures and its affiliates. The management fees and carried interests to Industry Ventures and its affiliates will not be reduced by any fees or carried interests paid to managers of portfolio funds."

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 funds in which they invest. Industry insiders estimate such multiple layers of costs and expenses amount to approximately 1.5 percent. Certain of these expenses may be disclosed in the annual report of the fund of funds.

Total asset management, operating fees and expenses related to a fund of funds investment may amount to **6 percent** or more annually or **\$2.4 million**.

In our opinion, due to the multiple layers of substantial fees related to fund of funds, the likelihood that these investments will deliver competitive net investment performance is remote.

Unless the new Treasurer demonstrates greater regard for escalating ERSRI's investment expenses than the former Treasurer, adding fund of funds to the pension portfolio will ensure that fees paid to Wall Street will continue to grow.

XIII. ERSRI Total Fees Estimated to Range From \$109 Million to \$161 Million—Not \$74.6 Million Disclosed

As discussed extensively in our 2013 report, it is well established that sponsors of public pensions 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.

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 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.

At the time of our initial request for fee information (in connection with our prior report), the fiscal year 2013 total

projected investment management fees disclosed on the former Treasurer's website were **\$11,563,979**, including real estate and other alternative investment manager fees of \$6,693,746.

Significantly, certain performance fees and other fees related to alternative investment managers, such as real estate, venture capital, private equity, hedge fund managers, were not disclosed.

Subsequently, total investment management fees for FY 2012 of approximately **\$46 million** were disclosed. FY 2013 total investment management fees, once finally disclosed amounted to **\$71.61 million**. FY 2014 total investment management fees disclosed amounted to **\$74.6 million**. However, to this day a footnote to the ERSRI fee table warns:

"Because indirect expenses are not readily separable from net investment income, the expenses disclosed here are provided on a best-efforts basis, intended to be used for illustrative purposes only."

In other words, the investment expenses disclosed have not been audited.

We concluded in our earlier report stating, "the total investment expenses may already, or in the near future, amount to a staggering almost **\$100 million** annually."

As discussed above, in this follow-up report we estimate total private equity **undisclosed** fees range from \$29 million to as

much as \$68 million and total real estate **undisclosed** fees range from \$6 million to as much as \$19 million.

In conclusion, it appears that ERSRI's total undisclosed investment expenses may range from **\$35 million to \$87 million.**

Thus, it appears that ERSRI's total fees (disclosed plus estimated undisclosed) as we predicted in our earlier report, are already well over \$100 million, i.e., range from a low of **\$109 million** to as high as **\$161 million.**

XIV. ERSRI and Auditor General Lack Knowledge and Diligence in Overseeing Alternative Investments

The Office of the Auditor General audits ERSRI annually as a separate entity. However, it is important to note that this is not a forensic audit conducted in order to prosecute a party for fraud, embezzlement or other financial claims. Given the heightened risks related to alternatives generally, as well as the pervasive wrongdoing identified by the SEC with respect to private equity, in our opinion, additional safeguards are needed with respect to ERSRI's 150 alternative investments.

The ERSRI financial reports made available to the public on the Treasurer's website, including the monthly Composite Reporting Investment Valuation (which categorizes which assets are alternatives and which are not) and the fiscal year direct and indirect investment expenses of private equity and

hedge fund managers,⁶³ are not verified or audited by the Auditor General.

As mentioned earlier, ERSRI claims to review the fees and expenses of the private equity and hedge funds but cautions “Because indirect expenses are not readily separable from net investment income, the expenses disclosed are provided on a best-efforts basis, intended to be used for illustrative purposes only.”

Given the SEC’s concerns regarding “bogus” fees, and the now widely acknowledged under-reporting of private equity fees by public pensions, this “best-efforts” review is hardly reassuring.

In our opinion, all investment expenses of alternative investments should be readily separable by the managers of those investments—if ERSRI or the Auditor General bothered to ask.

Obviously, the components of an overall fee must be known to an investment manager for the manager to compute the total fee legitimately.

Likewise, ERSRI should not pay, or permit any manager to deduct, any fee without disclosing the amount and nature of the fee. A pension fiduciary should never permit fees to be

⁶³ For some reason, a schedule of direct and indirect fees related to real estate managers is not made available to the public on the website. Given the opacity of the real estate alternative investments and myriad significant fees applicable, such as asset management, performance, property management and brokerage commissions, an expense analysis of these funds would be telling. Further, as mentioned earlier, ERSRI’s real estate is its worst performing asset class.

unilaterally taken by an investment manager without verification. To so allow, amounts to an invitation to steal.

The notion that any fees associated with alternative investment are not readily separable should be unacceptable to a pension fiduciary.

As mentioned earlier, in our opinion the monthly Composite Reporting Investment Valuations prepared by ERSRI significantly understate (by approximately 15%) the percentage of ERSRI assets subject to alternative investment costs and risks. It appears that the Auditor General generally accepts ERSRI's categorization of types of assets in Note 5(a) of his report.

In our opinion, both ERSRI and the Auditor General should disclose the greater percentage of assets which, by virtue of structure and assets, are properly categorized as alternatives.

As stated in Notes 3 and 5 to the ERSRI financial statements prepared by the Auditor General, approximately 24% of the holdings in the pooled investment trust are in hedge, private equity, and real estate investments. The Auditor General acknowledged to us that alternative assets pose heightened audit risk⁶⁴ and we agree.

In our opinion, the likelihood that there are adequate safeguards incorporated into the processes used by ERSRI and

⁶⁴ Conversation with State Auditor Dennis Hoyle, May 4, 2015.

Auditor General to verify the existence of the assets of approximately 150 high-risk opaque alternative funds custodied often offshore, subject to foreign regulation; the fair value of the assets of these funds; the fees and expenses, as well as potential violations of law; and the dozens of fund of fund investments, seems remote.

In connection with this investigation we brought to the attention of the Auditor General the SEC's recent findings of pervasive private equity wrongdoing—apparently for the first time.⁶⁵

While ERSRI and the Auditor General claim to obtain and review the audited financials of all of these 150 funds, as well as to communicate with hedge fund third party administrators, the complexities and still unfolding risks related to alternatives are enormous—even for regulators and the most seasoned investors.

For example, the Viking Global Equities offering document we reviewed⁶⁶ indicated that quarterly performance reports are unaudited and no securities positions are disclosed in the annual report provided to investors. Absent securities positions, the audited financials are worthless, in our opinion.

⁶⁵ Email to State Auditor Dennis Hoyle

⁶⁶ <https://s3.amazonaws.com/s3.documentcloud.org/documents/407978/viking-global-equities-lp-confidential.pdf>

Further, the Viking document discloses that the Administrator is not responsible for monitoring any investment restrictions or compliance with investment restrictions and therefore will not be liable for any breach thereof.

The Administrator does not assume any duty with respect to the accuracy of any information supplied to it by the General Partner. The Administrator is not an auditor and does not provide tax, accounting, or audit advice, nor is it a fiduciary to the Limited Partners.

Worse still, the Administration Agreement generally provides that the Partnership will indemnify the Administrator for any claim or loss short of gross negligence or fraud.

On May 18th we sent the following two emails to the Auditor General both of which went unanswered:

This (private equity) fund states that the audited financials will not disclose securities holdings. So how do you ascertain the value of the holdings?

How do you handle this issue: The Administrator does not assume any duty with respect to the accuracy of any information supplied to it by the General Partner. The Administrator is not an auditor and does not provide tax, accounting, or audit advice, nor is it a fiduciary to the Limited Partners.

In conclusion, it appears that neither the audited financials provided by alternative investment managers or the third party administrator reports provide the quality and quantity of

information required for a comprehensive review of the investments by ERSRI and the Auditor General. Additional safeguards are needed with respect to ERSRI's 104 alternative investments, in our opinion.

The addition of fund of funds with dozens of underlying investments will make an already formidable monitoring task even harder.

XV. 2016 Final Accounting of ERSRI's Point Judith Investment

As mentioned in our previous report, in 2006, former Treasurer Raimondo convinced ERSRI to invest in a venture fund she formerly managed at Point Judith Capital on different, less favorable terms. Unlike ERSRI which paid \$5 million for its shares in the Point Judith Venture Fund II, the former Treasurer was granted ownership interests in the fund for free, thereby diluting the state's interest in the fund.

In short, Raimondo profited at the expense of the pension—over the life of the investment.

We wrote that it was our understanding that the fee structure of the Point Judith funds was generally a management fee of 2.5 percent and 20 percent of profits. However, a Power Point presentation by Point Judith Capital to ERSRI, provided in response to our APRA request, stated that the terms of the

Point Judith II fund provided for a standard fee (2 percent average) and a carry (20 percent).

It was unclear to us why ERSRI would pay a higher fee than the fee stated in the presentation. ERSRI had not disclosed the fees paid to Point Judith at the time of our previous report.

If true, we noted, the fees paid to Point Judith by ERSRI were *significantly higher* than the then venture capital industry standard fees of 2 percent and 20 percent. Further, since Point Judith Capital was a small, unproven manager at the time of the investment by ERSRI there was no reason to believe the firm should have commanded a higher fee.

Subsequent to our report, ERSRI disclosed fees paid to Point Judith of 2.5 percent and 20 percent—the highest rate in its asset class. As stated in GoLocal Prov:

“Point Judith’s fee is 25 percent higher than the firm’s own standard rates, as advertised in its pitch book, a document that was provided to the State Investment Commission in 2007 when Raimondo was a partner at the firm and Frank Caprio was treasurer. The book states that Point Judith’s standard fees are a 2 percent management fee and 20 percent performance fee on any capital gains.

“I find 2 and 20 to be excessive. Two and a half—it’s just a little more excessive,” said Marcia Reback, a member of the State Investment

Commission and a former head of the Rhode Island Federation of Teachers and Health Professionals.”⁶⁷

In our prior report we noted that the former Treasurer had made numerous public statements regarding the performance of the Point Judith II fund, as well as released summary performance figures which were strikingly divergent. Based upon incomplete information she provided, the performance of the investment has ranged from her initial claim of 22 percent, to 12 percent, to 10.9 percent, to 6.2 percent, to 4 percent, to -16.7 percent.

In order to prevent any possible confusion or misleading of investors regarding the venture fund’s performance, we stated that, in our opinion it was appropriate to refer this matter to the SEC for investigation.

Since most venture capital funds have a fixed life of 10 years (with a possibility of a few years of extensions), the Point Judith II fund, with a 2006 vintage year, should be nearing its end.

Thus, a final accounting of the true performance of ERSRI’s \$5 million investment in Point Judith II should be forthcoming—results which ERSRI stakeholders should find of interest.

In the event that there has been any misrepresentation of past performance by the former Treasurer, her staff or others, the matter should be referred to the SEC.

⁶⁷ <http://www.golocalprov.com/news/raimondos-former-firm-highest-paid-by-state>

About Benchmark Financial Services, Inc.

Benchmark Financial Services, Inc. was founded by Edward “Ted” Siedle, a leading expert in forensic investigations of pensions, focusing upon excessive and hidden investment fees and risks, conflicts of interest and wrongdoing. A former SEC lawyer and industry executive with over 30 years experience, he has investigated over \$1 trillion in retirement plans. Prior investigations include the state of Rhode Island, state of North Carolina, the Alabama State Employees Pension, Wal-Mart, Cities of Nashville and Chattanooga, Town of Longboat Key, Caterpillar, Boeing, Northrup Grumman, John Deere, Bechtel, ABB, Edison, Shelby County, Tennessee, Fidelity Investments, JP Morgan, Sanford Bernstein, Banco Santander and the US Airways Pilots Pension.

Siedle is a nationally recognized authority on investment management and securities matter and has trained Department of Labor pension investigators around the country. 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, USA Today, Boston Globe, and Institutional Investor. He widely lectures and has appeared on CNBC, Wall Street Week, and Bloomberg News.

He writes about his groundbreaking findings as a contributor for Forbes. Millions read of his expert investigations on Forbes. Siedle was recently named as one of the 40 most influential people in the U.S. pension debate by Institutional Investor for 2014.

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” is 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.