Rhode Island Public Pension Reform: Wall Street's License to Steal

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.

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I. Executive Summary

Two years ago, Rhode Island's state pension fund fell victim to a Wall Street coup. It happened when 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 as the General Treasurer of the State of Rhode Island with the financial backing of out-of-state hedge fund managers. Raimondo's new role endowed her with responsibility for overseeing the state's entire $7 billion in pension assets.

In short, the foxes (money managers) had taken over management of the henhouse (the pension).

For Raimondo, a 42 year-old Rhode Island native, serving as state treasurer represents a major career boost. It also has presented her with an opportunity to enrich herself and her hedge fund backers at the expense of the state's pension fund, the public workers who are counting on it to finance their retirements and the taxpayers who could be stuck for millions, or billions, of dollars if it's mismanaged.

Key Finding:

The Employee Retirement System of Rhode Island has secretly agreed to permit hedge fund managers to keep the state pension in the dark regarding how its assets are being invested; to grant mystery hedge fund investors a license to steal, or profit at its expense using inside information; and to engage in potentially illegal nondisclosure practices.

Further, a significant portion of the Treasurer's wealth and income relates to shares she owns in two illiquid, opaque venture capital partnerships she formerly managed at Point Judith Capital—one of which she convinced the state to invest in on different, less favorable terms. Unlike the state which paid millions for its shares in one of the Point Judith funds, the Treasurer was granted shares in both of the venture capital funds for free.

Worse still, the venture capital industry is noted for its lack of transparency and once the Treasurer assumed office she refused to disclose virtually any information regarding the investment fund in which she and the state pension remain co-investors.

For example, the Treasurer refused to release documents which would reveal whether she (or any other investor) had been granted any special rights more favorable than those granted to the state, or other limited partners in the fund.

Point Judith Capital, the Treasurer's former employer, is a firm which is substantially funded by Tudor Investment Corp., a multi-billion dollar private equity and hedge fund conglomerate controlled by the secretive billionaire Paul Tudor Jones. Without Tudor as a strategic partner possessing a substantial investment performance history, Raimondo's Point Judith would not have been a contender for a $5 million venture capital commitment from the state.

In a very real sense, today Rhode Island's leading investment fiduciary is largely compensated by an out-of-state hedge fund investor—worse still, she is paid indirectly and secretly. The myriad unique conflicts of interest and risks related to this unprecedented state of affairs have not been thoroughly investigated or addressed.

Transparency and accountability have suffered as the pension has increased its allocation to hedge, venture capital and private equity

funds to almost $2 billion or 25 percent and the Treasurer has withheld most information about these high-risk, high-cost investments from both the State Investment Commission, a 10-member volunteer body that is chaired by the General Treasurer and oversees the investments of the state pension, and the general public. Ironically, in Rhode Island, limitations on public access to records have grown in the Information Age.

The Treasurer has emerged as the leading national advocate of a disingenuous form of public pension "reform" which involves slashing worker's benefits and thwarting public access to information regarding the riskiest of pension investments while, in secret, dramatically increasing the risks to retirement plans and the fees they pay to Wall Street. A report she produced in 2011 titled "Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System" made a stark case for the pension overhaul and benefits cuts she envisioned, while notably omitting details regarding the greater costs and risks related to her plans for restructuring the Fund's investment portfolio.

Benchmark Financial Services, Inc. ("Benchmark") was retained by Rhode Island Council 94 of the American Federation of State, County and Municipal Employees, AFL-CIO, to provide a preliminary expert forensic review of the investment program at the Employee Retirement System of Rhode Island ("ERSRI" or "the Fund"). We were also asked to examine whether the Treasurer's so-called reform agenda was actually enhancing the security and sustainability of ERSRI and the true costs and risks of the sweeping changes she has implemented.

- **Treasurer's Lack of Transparency**

Forensic investigations of pensions require access to evidence. It is fair to say that the Office of the General Treasurer of the State of Rhode

Island, through its actions has made conducting this review on behalf of participants in the Fund far more difficult.

There has been a sinister pall of secrecy regarding fundamental investment information related to the ERSRI (such as the level of investment advisory, performance and other fees paid for money management, the risks related to hedge, private equity and venture capital strategies and investments, and conflicts of interest) orchestrated by state officials and aided by key investment services providers, punctuated by periodic self-serving misrepresentations regarding such investment matters to the general public.

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The overwhelming majority of the information Benchmark requested for this review from the General Treasurer pursuant to the Rhode Island Access to Public Records Act (APRA) has been withheld in apparent violation of state law; the Treasurer claims the state is contractually obliged to defer to the money managers it has hired on the release of supposedly proprietary information. The worst is yet to come since the Treasurer has deliberately withheld the most potentially damaging information we have requested.

Most disturbing, from a regulatory and public policy perspective, is that the General Treasurer's practice of withholding information and intentionally providing incomplete disclosures regarding ERSRI's investments results in: (1) misleading the public as to

fundamental investment matters, such as the true costs and risks related to investing in hedge, private equity, and venture capital funds; (2) understating the investment expenses and risks related to ERSRI; and (3) misrepresenting the financial condition of the state of Rhode Island to investors.

For these reasons, it is recommended that this report, in general, be provided to securities regulators and law enforcement for appropriate action. However, other specific matters identified herein, i.e., apparent blatant illegalities involving billions in retirement assets nationally, such as hedge funds secretly profiting at the expense of public pensions across the country, demand an immediate, focused response by securities regulators and law enforcement, in our opinion.

Recently, 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 released a letter to the Treasurer voicing their concerns regarding the Treasurer's strategy of withholding hedge fund records. These groups believe that since the financial reports are paid for with public funds and detail how the state is investing the public's money, they should be made public in their entirety; further they found "troubling" the Treasurer's decision to allow the hedge funds to decide what information to release.

Blatant illegalities involving billions in retirement assets nationally, such as hedge funds secretly profiting at the expense of public pensions across the country, demand an immediate, focused response by securities regulators and law enforcement.

The groups should be alarmed— secrecy is critical to the Treasurer's pension "reform" wealth transfer scheme and she is, in effect, rewriting the rules applicable to public access to state investment information in Rhode Island to accomplish this objective.

- **So-Called Pension Reform Scheme Permanently Reduces Benefits To Retirees**

The Rhode Island Retirement Security Act of 2011, enacted November 18, 2011, suspended the Cost of Living Adjustment ("COLA") for all state employees, teachers, state police and judges, until ERSRI's funding level for all groups, calculated in the aggregate, exceeds 80 percent.

Under the new law, the COLA is targeted at two percent and will be calculated by subtracting 5.5 percent from ERSRI's five-year average investment returns and will range from 0 to 4 percent.

Whether retirees receive any COLA will depend upon both ERSRI's funding level and the Fund's actual investment returns—both of which are volatile, unpredictable and subject to manipulation by elected officials and others. The manipulation of both of these key goalposts has already begun.

In April 2011, the State Retirement Board lowered the state's assumed rate of return from 8.25 percent to 7.5 percent. A recent new report by an actuarial firm hired by the Treasurer concluded that the State Retirement Board should "consider lowering" the assumed 7.5 percent rate of return even further. To the surprise of even the actuarial firm issuing the new report, the Treasurer claimed the suggestion that the reduced assumption of 7.5 percent may be too optimistic was "terrific news … the numbers are accurate."

The Treasurer has publicly stated that the investment assumption will be reviewed next summer and has acknowledged that the impact of any such future reduction on ERSRI's funding level could "be big." Based upon reliable sources, it is our understanding that the actuaries have agreed to strategically recommend, over time and in steps, further reducing the investment assumption to 6 percent—massively increasing ERSRI's underfunding.

As the investment assumption has been ratcheted downward increasing ERSRI underfunding, the investment expenses have been manipulated upward.

The staggering, almost 700 percent planned increase in ERSRI's investment expenses (disclosed to date) 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, further reducing the likelihood of a COLA payment.

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, earning a mere 11.07 percent versus 12.43 percent for the median public-sector pension during the 12 months ended June 30, 2013. If the hedge fund managers continue to perform as badly as they

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have to date, the damage to ERSRI will be substantially greater—hundreds of millions annually.

In summary, the likelihood that any meaningful COLA will ever be paid in the future under the new statutory scheme is remote—a fact which has not been shared with workers and retirees.

The projected cost to ERSRI of the Treasurer's $2 billion alternative investments gamble far exceeds the COLA savings the Treasurer has projected.

On the other hand, 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 forseeable and foreseen, i.e., intentional.

Most revealing, the projected cost to ERSRI of the Treasurer's $2 billion alternative investments gamble over the next 20 years amounts to in excess of $3 billion and far exceeds the COLA savings the Treasurer has projected—another inconvenient truth that, to date, has been withheld from the public.

Public pension reform, in Rhode Island, amounts to a transfer of worker's wealth dollar-for-dollar to Wall Street.

- **SEC Should Investigate ERSRI's Failure to Disclose Skyrocketing Investment Expenses**

The investment management expenses disclosed in ERSRI financial reports to date have been grossly understated by the Treasurer. While retirement plan fiduciaries are required to monitor the reasonableness of plan fees and expense, the Treasurer initially indicated, when asked, that she did not know the amount of fees ERSRI paid to its investment managers.

Further, since these financial reports provided to the State Investment Commission which oversees the pension materially understate fees, the Treasurer has ensured the SIC cannot possibly and has not ever reviewed whether the fees the ERSRI pays to its hedge, private equity and venture capital managers are reasonable or excessive.

The Treasurer has intentionally withheld from the public and the SIC information about the soaring investment fees which is material in assessing both whether ERSRI should invest in costly alternative investments and whether benefit cuts are necessary to improve pension funding.

In our opinion, based upon our knowledge of pension investment operations, an investigation by state or federal securities regulators would reveal intentional withholding of material information and misrepresentations regarding state pension costs, as

The Treasurer has intentionally withheld information about soaring investment fees which is material in assessing both whether ERSRI should invest in costly alternative investments and whether benefit cuts are necessary to improve pension funding.

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opposed to a lack of knowledge about the exponential growth and magnitude of the fees.

Given the myriad fees related to alternative investments; the industry's lack of transparency and pervasive conflicts of interest, as well as the Treasurer's unwillingness to disclose total fees promptly, the ERSRI investment expenses for FY 2012, which over the past six months have been disclosed by the Treasurer as growing from $10.6 million; to $33.1 million; then $43.3 million, continue to be materially understated.

Further, ERSRI investment expenses for FY 2013, which have been estimated by the Treasurer as growing from $11.5 million; to $47.5 million; then $70 million, continue to be materially understated.

The additional expenses, which remain undisclosed to date, combined, can easily exceed 2 percent annually—in addition to the already excessive 2 percent asset-based and 20 percent performance fees alternative investment managers typically charge—adding tens of millions to ERSRI's already soaring disclosed annual investment expenses.

In conclusion, ERSRI's total investment expenses may already, or in the near future, amount to a staggering almost $100 million annually— an amount far in excess of the $5 million cost of conservatively indexing or passively managing the Fund's assets.

- **Lose-Lose: Alternative Investments Both Reduce Returns and Increase Risk**

The Treasurer early on stated that superior investment performance justifies the high fees hedge funds charge; however, as ERSRI's reported investment performance has continued to significantly lag behind its peers, the Treasurer has acknowledged that her new investment strategy utilizing hedge funds could reduce the upside potential for ERSRI's investments.

The loss of upside return at ERSRI is apparent at this time, as the Fund has underperformed the market by hundreds of millions of dollars in the past year alone according to the financial statements; however, the amount of any potential downside protection afforded by the alternatives is unproven and unknown. Thus, it is impossible for the fiduciaries of the Fund, i.e., the State Investment Commission, to assess whether the massive cost related to any supposed risk reduction is reasonable.

In order to determine whether the hedge fund investments owned by ERSRI lower the pension's risk (as the Treasurer has repeatedly represented), Benchmark reviewed the offering memoranda related to many of these investments obtained from independent sources—since the Treasurer refused to provide the documents.

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The Treasurer's representations regarding the level of risk related to ERSRI's hedge fund investments are wholly inconsistent with the hedge fund managers' own words.

Since the managers may completely change their investment strategies at any time, there is no way ERSRI can ensure that the hedge funds are providing any diversification whatsoever—contrary to representations by the Treasurer.

wholly inconsistent with the hedge fund managers' own words. The offering documents prominently warn that an investment in a hedge fund is speculative, involves a high degree of risk, and is only suitable for persons who are willing and able to assume the risk of losing their entire investment—hardly an appropriate investment for a public pension plan.

While ERSRI's hedge funds generally disclose specific risks related to investment strategies they may pursue, the managers have wide latitude to invest or trade their fund's assets, and to pursue *any* particular strategy or tactic deemed advisable by the manager—all without obtaining ERSRI approval.

Since the managers may completely change their investment strategies at any time, there is no way ERSRI can ensure that the hedge funds are providing any diversification whatsoever—contrary to representations by the Treasurer. For example, all the hedge fund managers could invest in a single asset class, say cash, or a single stock, say Enron, at an inopportune time.

- **ERSRI Agrees To Be Kept In The Dark, Grants Mystery Investors Licenses to Steal and Consents To Potential Nondisclosure Illegalities**

The offering documents of the hedge funds reveal that investors, such as ERSRI, agree to permit hedge fund managers to withhold complete and timely disclosure of material information regarding ERSRI's investment in their funds. In the words of one manager, investors "will not have the objective means by which to evaluate its operation or to determine whether it is being followed… further, investors may not have the ability to review the investment positions." Shockingly, ERSRI fiduciaries have consented to being kept in the dark, abrogating their duty to monitor and safeguard pension assets.

Worse still, ERSRI agrees to permit the hedge fund managers to retain absolute discretion to provide certain mystery investors with greater information about investment strategies and portfolio holdings and the managers are not required to disclose such arrangements to ERSRI. As a result, the hedge fund managers expressly warn that ERSRI is at risk that other unknown investors may profit at its expense.

The absolute discretion ERSRI has granted to certain managers amounts to a license to steal from the state pension.

The outrageous nondisclosure policies detailed in the hedge fund offering documents cause these investments to be, at a minimum, inherently impermissible for a public pension, such as ERSRI, if not illegal.

The identity of any mystery investors permitted to profit at ERSRI's expense, as well as any relationships between these investors, the Treasurer or other public officials should be investigated fully by securities regulators and law enforcement.

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 detailed in the hedge fund offering documents cause these investments to be, at a minimum, inherently impermissible for a public pension, such as ERSRI, if not illegal.

However, given that public pension investments in alternative investments have doubled in recent years (now amounting to 24 percent of portfolios) and billions in public pension assets across the country are currently at risk from such hedge fund schemes, the need for an immediate, focused response by securities regulators and law enforcement is compelling.

Finally, 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 be investigated fully by law enforcement and securities regulators—especially since leading hedge fund insiders have financially supported the pension "reform" that gave rise to these hedge fund hirings and related mysterious arrangements.

- **Heightened Risks Related To Hedge Fund Offshore Regulation And Custody**

Some of the hedge funds in which ERSRI invests are incorporated and regulated under the laws of foreign countries, presenting additional, unique risks. There is no evidence the State Investment Commission was aware of, or ever considered, the unique risks related to foreign regulation of hedge funds.

Likewise, since ERSRI's alternative investment assets are held at different custodian banks located around the world, as opposed to being held by ERSRI's master custodian, the custodial risks are heightened and should have been considered by the State Investment Commission.

When a member of the SIC requested information regarding the names and locations of the ERSRI's hedge fund custodians recently, Chief Investment Officer Anne-Marie Fink responded, "we don't have a single document that lists all the funds and all the custodians." Obviously, if ERSRI did not have such a document, the SIC could not have ever reviewed the many different custodians for safety and soundness.

While withholding such important investment information regarding hedge funds from the SIC may make it easier for the Treasurer to claim such information is proprietary and deny public record requests consistent with her pension "reform" agenda, it effectively undermines the SIC's ability to oversee ERSRI's riskiest investments.

There is no evidence the State Investment Commission was aware of, or ever considered, the unique risks related to foreign regulation of hedge funds.

The Treasurer has made numerous public statements regarding the performance of the Point Judith II fund she formerly managed and sold to ERSRI, as well as released summary performance figures which are strikingly divergent.

- **SEC Should Investigate Questions Surrounding ERSRI's Point Judith Venture Investment**

It appears that the 2.5 percent asset-based and 20 percent performance fees paid to Point Judith by ERSRI are significantly higher than the then venture capital industry standard of 2 percent asset-based and 20 percent performance fees. Since Point Judith Capital was a small, unproven manager at the time of the investment by ERSRI, there is no reason to believe the firm should have commanded a higher fee. The limited records provided indicate that Tudor's track record and expertise were paramount in the Point Judith Capital proposal to ERSRI; absent Tudor as a strategic partner and investor, Point Judith would not have been able to compete for a $5 million venture capital allocation from ERSRI.

The Treasurer has made numerous public statements regarding the performance of the Point Judith II fund, as well as released summary performance figures which are strikingly divergent. Based upon incomplete information she has 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 conclusion, as a result of the Treasurer's refusal to publicly disclose all of the material information regarding Point Judith Capital and the Point Judith II fund she formerly managed and sold to ERSRI,

choosing instead to disclose limited unverified information which is wildly inconsistent, it is impossible for the general public, participants and taxpayers to assess her and the firm's investment capabilities, as well as whether ERSRI should have ever invested, or should remain invested, in the Point Judith II fund.

This lack of disclosure is especially troubling since it is our understanding that Point Judith Capital is soliciting investors at this time for a new investment fund. To the extent that any investment information publicly disseminated regarding past performance of the firm, or its funds, is inaccurate, potential new, as well as existing investors may be misled.

In order to prevent any possible confusion or misleading of investors, it is appropriate to refer this matter to the SEC for investigation.

In order to prevent any possible confusion or misleading of investors, the SEC should investigate Point Judith II performance claims.

- **Rhode Island Ethics Commission Opinion And "Blind Trust" Fail to Address Conflicts Regarding Point Judith Investment**

In a letter to the Rhode Island Ethics Commission requesting an advisory opinion concerning whether she had taken sufficient steps to avoid conflicts of interest relative to her ties to a venture capital fund in which the state had made an investment, the Treasurer represented that in 2007 the State Investment Commission entered into a ten-year contract with Point Judith in which the State agreed to invest $5 million dollars in the Point Judith II fund.

The Treasurer notably failed to mention in her letter to the Ethics Commission that the state was a limited partner in the Point Judith fund and may have broad rights in the fund that conflict with hers. Further, she may have special rights that permit her to profit at the state's expense.

She also represented that the State's investment in the fund was passive, meaning that after signing the contract with Point Judith and making its investment commitment, the State Investment Commission had no say in the fund's ongoing management or investment decisions.

The Treasurer notably failed to mention in her letter to the Ethics Commission that the state had not merely entered into a ten-year contract with Point Judith. Rather, the state was a limited partner in a fund managed by Point Judith as General Partner and, as a limited partner the state may have broad rights in the fund's ongoing management, or investment decisions, the exercise of which may conflict with her rights and interests.

Further, as a Point Judith insider, she, or other investors, may have been granted special rights more favorable than those granted to the state, including special withdrawal rights; rights to receive reports from the partnership on a more frequent basis or that include information not provided to other limited partners; rights to receive reduced rates of the incentive allocation and management fee; rights to receive a share of the incentive allocation, management fee or other amounts earned by the general partner or its affiliates. If true, the Treasurer may literally be profiting at the expense of the state.

Since the Treasurer has refused to disclose documents related to the Point Judith II fund, as well as her and ERSRI's investment in the fund, the public

cannot know whether permitting the co-investment to continue is harmful to the Fund. Regardless, the characterization of the investment in the Point Judith II Fund as merely a ten-year contract in a passive investment as to which the state had no say is neither complete nor accurate.

In order to create further separation from her investment in the Point Judith funds, the Treasurer represented that prior to assuming office she placed all her right, title and interest in both funds into a blind trust designated as the Raimondo Blind Trust. While a blind trust may be of value in certain circumstances, where, as here, the sole assets of the trust, i.e. the shares in the two Point Judith funds, are illiquid, i.e. cannot be sold for a decade, no protection is afforded. The purpose of the blind trust is to keep the beneficiary unaware of the specific assets of the trust, so as to avoid a conflict of interest between the beneficiary and the investments.

In this case, the Treasurer knows precisely the assets held in the Blind Trust during her entire term as Treasurer and continues to enjoy cash distributions related to the Point Judith funds—payments exponentially greater than her state salary in the past year— and payments related to shares she was granted for free.

Rather than provide protection against conflicts, here the blind trust serves to enable the conflict of

The Blind Trust scheme the Treasurer proposed to the Ethics Commission, coupled with her nondisclosure policy regarding the Point Judith II fund, has resulted in only the public being "blind" as to the Point Judith II fund.

The Raimondo Blind Trust constitutes a misuse of the blind trust device.

The investment consultant retained to provide objective advice regarding alternatives, Cliffwater LLC, has disclosed it receives compensation from investment managers it recommends to clients, including Brown Brothers Harriman which manages $272 million for ERSRI.

interest involving ERSRI to persist throughout her term.

Most important, in connection with granting the Advisory Opinion, the Treasurer did not indicate, and Ethics Commission did not consider, that the Treasurer would subsequently refuse to disclose to the public information regarding ERSRI's investment in Point Judith II.

Ironically, the Blind Trust scheme she proposed to the Ethics Commission coupled with her nondisclosure policy regarding the Point Judith II fund, has resulted in only the public being "blind" as to the Point Judith II fund.

In short, in our opinion, this arrangement constitutes a misuse of the blind trust device.

- **SEC Should Investigate ERSRI Investment Consultant Conflicts, Payments From Money Managers**

The investment consultant retained by ERSRI to provide objective, independent advice regarding alternative investments, Cliffwater LLC, has disclosed in its regulatory filings with the SEC that it receives compensation from the very investment managers it recommends or selects for its clients. The amount and sources of such compensation have not been disclosed to ERSRI or anyone else and Cliffwater has changed its disclosure regarding such payments in its

SEC filings during the course of this review, as a result of recent questions we have raised.

Further, Cliffwater representatives have admitted elsewhere that the firm receives an undisclosed amount of compensation from at least one prominent ERSRI manager, Brown Brothers Harriman—a firm which manages approximately $272 million for the ERSRI and is also a private equity manager.

Based upon responses to records requested, it is apparent that ERSRI has never asked Cliffwater for detailed information necessary to evaluate potential conflicts of interest related to payments received from money managers, such as the names of the managers and amounts paid to Cliffwater. While the effort related to investigating any such conflicted payments to Cliffwater is minimal, the potential harm to the pension if Cliffwater's recommendations have been tainted is enormous.

Cliffwater's substantial investment manager client-base, recent changes to its SEC disclosures and inconsistent statements made by representatives of the firm to public pension trustees all constitute, in our opinion, "red flags." Given the SEC's past regulatory focus on pervasive pension consultant industry conflicts of interest, a referral for investigation by the SEC is warranted.

SEC should investigate "red flags" at Cliffwater—its substantial investment manager client-base; recent changes to its SEC disclosures; and inconsistent statements made by representatives of the firm to public pension trustees.

Rather than undertake an independent investigation in response to an SEC inquiry, ERSRI relied upon its then investment consultant, PCG, for objective advice regarding controversial placement agent fees—at a time when PCG itself was embroiled in a national pay-to-play scandal.

- **"Pay To Play" Placement Agent Abuses at ERSRI**

Contrary to the Treasurer's public statements prior to this investigation, undisclosed placement agent fees were paid by ERSRI's investment managers to intermediaries or middlemen for selling their investment products to ERSRI.

In response to our APRA request, the Office of the General Treasurer indicated that ERSRI had received a confidential inquiry from the SEC regarding placement agents on May 8, 2009. The state's response to the SEC indicated, at the outset, that ERSRI had not undertaken any independent investigation of the facts stated therein.

Given that the role and compensation of placement agents had become a highly controversial issue nationwide by 2009 and that the risks, as well as potential recoverable fees and damages related to placement agents were significant, the lack any meaningful fiduciary response, i.e., an independent, thorough investigation, by ERSRI to the SEC inquiry was, in our opinion, inexcusable.

Rather than undertake an independent investigation, ERSRI relied upon advice provided by its then private equity consultant, Pacific Corporate Group Asset Management. At the very time ERSRI was relying upon PCG for objective, independent advice regarding controversial placement agent fees under

scrutiny by regulators and law enforcement, it was revealed in published reports (which were easily accessible to ERSRI), that PCG itself was embroiled in a national pay-to-play scandal involving the firm's relationship with former CalPERS board member turned placement agent, Alfred Villalobos. Villalobos, who reaped more than $58 million in placement agent fees, was indicted for fraud earlier this year.

The Fund has not in the years following the SEC inquiry undertaken any subsequent independent investigation to verify the full extent of any placement agent fees paid and related damages, or sought to recover even the known placement agent fees, or consulting fees paid to PCG for objective, as opposed to tainted, advice.

Given that the advice the pension received from PCG was, at a minimum, conflicted and potential violations of law may exist, in our opinion, a subsequent independent investigation should have been undertaken.

Recently, over $1 million in secret placement agent fees (which were previously confidentially disclosed to the SEC) have finally been disclosed to the public by ERSRI in response to our APRA requests. Most flagrant, the largest placement agent fee disclosed ($437,500)—paid to a highly controversial agent (Diamond Edge)—related to an investment as to which ERSRI's private equity consultant, PCG, had also received millions in placement agent fees. There

Most flagrant, there was no need to pay anyone the largest placement agent fee ERSRI paid.

The squandering of these placement agent fees has never been investigated by ERSRI.

was absolutely no need to pay anyone hundreds of thousands of dollars to "introduce" PCG or ERSRI to the investment that PCG was already familiar with. The squandering of these placement agent fees has never been investigated by ERSRI.

On September 20, 2013, AFSCME agreed to pay ERSRI $2,385.00 for additional information regarding placement agent fees that the Treasurer's office has refused to provide for free.

It is highly likely, in our opinion that additional fees were paid in the past that have not been disclosed to the SEC, or anyone else, by ERSRI. In the event that there are additional undisclosed placement agent fees at ERSRI, regulators and possibly law enforcement should be notified.

II. Introduction

On May 30, 2013, Benchmark Financial Services, Inc. was retained by Rhode Island Council 94 of the American Federation of State, County and Municipal Employees, AFL-CIO, to provide a preliminary expert forensic review of the investment program at the Employee Retirement System of Rhode Island ("ERSRI" or "the Fund"). That is, we were asked to examine whether the Treasurer's so-called reform agenda was actually enhancing the security and sustainability of ERSRI and the true costs and risks of the sweeping changes she has implemented.

Council 94 is one of the oldest and largest public employee unions in Rhode Island representing approximately 8,000 members. It is made up of approximately 65 local unions in most state agencies and cities and towns in Rhode Island.

The organization also represents private sector workers and workers in quasi-public agencies including the Narragansett Bay Commission, the Rhode Island Airport Corporation and First Student school bus drivers. Its locals range in size from 8 members to more than 500 members. The organization has several contracts with the State of Rhode Island including a master contract covering over 5,000 state employees and dozens of contracts in cities, towns and school districts.

Council 94 is affiliated with the American Federation of State, County and Municipal Employees ("AFSCME") International which has more than 1.6 million members from Hawaii to Maine to Puerto Rico. AFSCME is the largest union in the AFL-CIO which is the largest federation of unions in the United States, made up of 56 national and international unions, together representing more than 11 million workers.

In this preliminary investigation, Benchmark has focused upon: (1) radical recent (and future projected) changes to ERSRI's investment

assumption and allocation of assets to high-risk, high-cost alternative investments, as well as the impact of these changes upon benefits paid to retirees; (2) skyrocketing, here-to-for undisclosed investment expenses of the Fund; (3) heightened risks related to ERSRI's substantial allocation of assets to alternative investments, including nondisclosure policies, illiquidity, valuation and custodial; (4) fiduciary concerns surrounding ERSRI's investment in the Point Judith II venture capital fund formerly managed by the General Treasurer, in which the Treasurer remains a co-investor; (5) potential conflicts of interest related to payments received from money managers by the investment consultant retained by the Fund as a fiduciary to provide objective advice regarding hedge funds, venture capital and private equity investments, Cliffwater, LLC; (6) abuses related to previously undisclosed "pay-to-play" payments by ERSRI's investment managers to undisclosed intermediaries, i.e., "placement agents."

III. Lack of Transparency At ERSRI

Forensic investigations of pensions require access to evidence. It is fair to say that the Office of the General Treasurer of the State of Rhode Island, through its actions has made conducting this review on behalf of participants in the Fund far more difficult.

While the General Treasurer has publicly stated a commitment to transparency, as discussed more fully below the information regarding ERSRI provided by her and her office to the public is often both intentionally incomplete and misleading, in our opinion.

There has been a sinister pall of secrecy regarding fundamental investment information related to the ERSRI (such as the level of investment advisory, performance and other fees paid for money

management, the risks related to hedge, private equity and venture capital strategies and investments, and conflicts of interest) orchestrated by state officials and aided by key investment services providers, punctuated by periodic self-serving misrepresentations regarding such investment matters to the general public.

The overwhelming majority of the information we have requested from the General Treasurer pursuant to the Rhode Island Access to Public Records Act (APRA) has been withheld from us, as well as from participants in the pension, in apparent violation of state law, as detailed below.

Responses by the General Treasurer to our ARPA requests, as well as the request of others, fall into three categories.

1. **Free Information**: Certain information which may have appeared to be supportive of the Treasurer's investment decision-making, such as incomplete documentation related to her much-touted placement agent disclosure policy, was initially provided to us at no cost. Subsequently, greater, yet still incomplete, information regarding investment managers and fees (including documents which, as indicated below, AFSCME was told it would have to pay for), was provided to Mike Stanton, a reporter at the local newspaper the Providence Journal, at no cost. Clearly, the identity of the party requesting the information, as well as the Treasurer's assessment of its likely impact or intended use, have been factors the Treasurer has considered in determining whether any payment for information regarding ERSRI would be required.
2. **Pricey Information**: With respect to certain other readily-available information, including information necessary to verify or complete the record as detailed in material publicly released or

provided to us "for free" (such as investment contracts referencing placement agent fees paid), the payment of substantial fees, as indicated below, was required. A total of approximately $5,000.00 in fees was demanded for the information we and AFSCME requested. Further, the Treasurer's Office indicated that payment of such substantial fees did not guarantee that the complete information would be provided.

3. **Forbidden Information** (i.e., information that will not be disclosed to the public at any price): The overwhelming majority of the key information we, AFSCME and others have requested regarding the Fund's investments, such as the offering documents, annual reports, cash flow statements and performance appraisals regarding the Point Judith II venture capital fund which the Treasurer formerly managed, solicited the Fund to invest $5 million, and continues to personally invest in; offering documents disclosing the performance and asset-based fees, leverage, illiquidity and valuation risks related to the Fund's numerous alternative investments, as well as any placement agents involved, the Treasurer refused to provide to anyone at any price.

All of the information we and AFSCME requested was readily available and of a financial nature of obvious materiality to participants in the Fund, taxpayers and investors.

Most disturbing, from a regulatory and public policy perspective, is that the General Treasurer's practice of withholding relevant information and intentionally providing incomplete disclosures regarding ERSRI's investments results in: (1) misleading the public as to fundamental investment matters, such as the true costs and risks related to investing in hedge, private equity, and venture capital funds; (2) understating the

investment expenses and risks related to ERSRI, even as she and her office publicize data to support her contention that ERSRI cannot afford to pay certain benefits to participants; and (3) misrepresenting the financial condition of the state of Rhode Island to investors in state obligations.

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

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

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

In our opinion, there is simply no reason participants in the ERSRI, who rely upon the investment decisions made by the Fund for their retirement security, should be provided with less information, afforded less protection under the federal securities laws, than investors who are members of the general public.

For this reason, this report in general, as well as specific matters raising regulatory concerns identified herein, should, in our opinion, be provided to state and federal securities regulators for appropriate action, if any.

IV. Four Open-Government Groups Challenge Treasurer's Refusal To Disclose Hedge Fund Information

In a letter released August 8, 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 records from the Providence Journal. The groups were reacting to an August 3, 2013 Providence Journal story about the state's hedge fund investments.[1]

These groups believe that since the financial reports are paid for with public funds and detail how the state is investing the public's money, they should be made public in their entirety; further they found "troubling" the Treasurer's decision to allow the hedge funds to decide what information to release. The groups should be alarmed— secrecy is critical to the Treasurer's pension "reform" wealth transfer scheme and she is, in effect, rewriting the rules applicable to public access to investment information in Rhode Island to accomplish this objective.

As detailed below, the Journal was neither the first nor the only party to request reports detailing ERSRI's hedge fund operations and fees. AFSCME and Benchmark, as well as others,[2] had been requesting information regarding ERSRI's hedge fund and other alternative investments at least since the beginning of 2013 pursuant to APRA. We had all been provided far less information than the Providence Journal.

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[1] Open-Government Groups Challenge Raimondo on hedge-fund information, Providence Journal, August 8, 2013.

[2] Will Rhode Island's big bet on hedge funds pay off? Providence Journal, August 3, 2013.

Refusing to disclose to the public, including participants in the state pensions, material information regarding high-cost, high-risk speculative investment schemes is, in our opinion, bad enough. Far more indefensible is the Treasurer's claim that the state is contractually obliged to defer to the hedge fund and alternative managers on the release of so-called proprietary information. Delegating to private entities the decision as to what records are available under the state open-records law would, obviously, effectively nullify it.

Further, as discussed below, for the chief fiduciary to a pension to agree to permit investment managers to not provide material information regarding investment strategies and portfolio holdings related to ERSRI assets they have been entrusted with constitutes a complete abrogation of the duty to safeguard pension assets.

While the Treasurer claims that hedge fund manager opposition to release of material information about their operations to any party precludes disclosure, in our professional experience that's unlikely. If the Treasurer or State Investment Committee wanted ERSRI information made public, the investment managers, faced with losing the assets, would comply.

Benchmark routinely reviews such hedge fund documents on behalf of pensions and participants in plans and, as indicated below, was able to obtain the supposedly secret documents related to many of ERSRI's hedge fund managers.

On the other hand, if the managers are truly unwilling to submit to public scrutiny, i.e., comply with applicable public disclosure laws, they should not be entrusted with the management of public assets.

Ironically, a review by the Wall Street Journal of more than 100,000 federal Freedom of Information Act requests recently revealed that hedge fund managers have been using open-government laws to troll for financially-relevant information to fuel their profits. “It’s an information arms race,” one manager is quoted as saying. “It’s important to try every avenue. If anyone else is doing it, you need to do it too.”[3]

To permit hedge funds to mislead the public and profit from thwarting open-government laws is contrary to sound public policy.

V. Pension “Reform” Scheme Suspends, Likely Ends Future Cost of Living Adjustments (COLA) For Retirees

A. Lowering ERSRI Investment Return Assumption Increases Unfunded Liability

In 2011, ERSRI retirees received average state pensions of $28,303 annually and average municipal pensions of $15,040 annually. In addition, a COLA of approximately 3% was paid to supplement retiree income.

In April 2011, the State Retirement Board lowered the state’s assumed rate of return from 8.25 percent to 7.5 percent. In doing so, it increased ERSRI’s unfunded liability by more than $150 million. At that time, the Treasurer stated, “While this is a more realistic rate of return, the actuaries have warned that the state only has a 42.5 percent chance of achieving this target.[4] Currently, the state’s assumed investment return remains at 7.5 percent.

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

[4] Truth in Numbers, The Security and Sustainability of Rhode Island’s Retirement System, Office of the General Treasurer, .June 2011.

A new report by an actuarial firm hired by the Treasurer concluded that the State Retirement Board should "consider lowering" the assumed 7.5 percent rate of return even further. There is only a 40 percent chance returns will meet the current 7.5 percent assumption over the next 20 years, the firm believes.

The Treasurer has publicly stated that the investment assumption will be reviewed next summer and has acknowledged that the impact of any such reduction upon ERSRI's funding level could "be big." Even if the return assumption is reduced to 7 percent, ERSRI's actuary says the Fund would only have a 50 percent chance of meeting its investment goal.[5]

It is our understanding that the actuaries have agreed to, over time and in steps, recommend further reducing the investment assumption to 6 percent—massively increasing ERSRI's underfunding.

To the surprise of even the actuarial firm involved, the Treasurer publicly claimed the new report's suggestion that the reduced assumption of 7.5 percent may be too optimistic is good news:

> "This is really terrific news today, that they got it all right," she said. "The audit shows the numbers are accurate."[6]

B. "Costly" COLA For Retirees Suspended

The Rhode Island Retirement Security Act of 2011, enacted November 18, 2011, suspended the COLA for all state employees, teachers, state

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[5] R.I. pension fund advisers suggest state consider further reduction of annual returns, Providence Journal, September 12, 2013.

[6] Id. If the likelihood that the pension will meet its current investment return assumption has fallen from 42.5 percent to 40 percent, that's hardly confirmation that the assumption is correct.

police and judges, until ERSRI's funding level for all groups, calculated in the aggregate, exceeds 80 percent. The suspension took effect on July 1, 2012.

According to the Treasurer's website, "The COLA is one of the most expensive aspects of the current pension system (continuing to pay out a COLA may eventually deplete the pension fund if the 7.5 percent investment return assumption is not achieved)."

In 2011, the Treasurer stated, "it has been estimated that a suspension of the COLA for all active and retired members until the plan is 80 percent funded would reduce the unfunded liability by approximately $1 billion.[7] More recently, the Treasurer's office has stated that projected savings from COLA reductions are far greater, amounting to $2.3 billion over the next 20 years. No supportive material has been provided for either of these widely divergent estimated or projected COLA savings amounts.

Under the new law, the COLA is targeted at 2 percent and will be calculated by subtracting 5.5 percent from ERSRI's five-year average investment returns and will range from 0 to 4 percent.

According to an example on the Treasurer's website, if a COLA is being provided and the Fund performs at the five-year average of 7.5 percent, a COLA of two percent would be applied to retirees' pensions. If ERSRI's five-year average investment return is 9.5 percent, retirees would benefit from a higher-than-assumed investment return and receive a COLA of four percent. But if ERSRI's returns five-year investment gains of less than 5.5 percent, there would be no COLA awarded.

[7] Truth in Numbers, The Security and Sustainability of Rhode Island's Retirement System, Office of the General Treasurer, .June 2011.

ERSRI's funding level as of June 30, 2012 was 56.3 percent—far below the 80 percent required for a COLA to be paid to workers; investment returns over the past five years have averaged 5.07 percent, according to the Treasurer's office— approximately 10 percent below the minimum required for a COLA award.

In summary, whether retirees receive any COLA will depend upon both ERSRI's funding level and the Fund's actual investment returns—both of which are volatile, unpredictable and subject to massive manipulation by elected officials and others. The manipulation of both of these key goalposts has already begun.

C. COLA Killers: As Investment Assumption Plummets, Fees Paid To Wall Street Skyrocket

As mentioned above, the Treasurer has admitted she intends to lower the investment return assumption in the future and acknowledged that doing so will significantly increase ERSRI's underfunding below the current 56.3 percent and further away from the 80 percent required for a COLA to be paid to workers. However, the Treasurer has not disclosed the massive increase in underfunding which will result from reducing the assumption to the secretly agreed target of 6 percent.

As the investment assumption has been ratcheted downward increasing ERSRI underfunding, the investment expenses have been manipulated upward.

The staggering, almost 700 percent planned increase in ERSRI's investment expenses (disclosed to date) 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, further reducing the likelihood of a COLA payment. If the hedge fund managers continue to perform as badly as they have

to date, the damage will be substantially greater—hundreds of millions annually.[8]

In summary, the likelihood that any meaningful COLA will ever be paid in the future under the new statutory scheme is remote—a fact which has not been shared with workers and retirees.

On the other hand, the so-called "pension reform" scheme as executed by the Treasurer (gorging on high-cost alternative investments), guarantees investment-related fees paid to Wall Street will continue to climb to approach $100 million—an outcome which was both forseeable and foreseen, i.e., intentional.

Most revealing, the projected cost to ERSRI of the Treasurer's $2 billion alternative investments gamble over the next 20 years amounts to in excess of $3 billion and far exceeds (by almost $1 billion) the COLA savings the Treasurer has projected—another inconvenient truth that, to date, has been withheld from the public.[9]

VI. Treasurer's History Of Grossly Understating ERSRI's Investment Expenses

A. Fiduciary Duty To Ensure Investment Fees Are Reasonable

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

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[8] In FY 2013, ERSRI's hedge fund investments underperformed the Russell 3000 index by $100 million.

[9] Public employee unions are currently challenging the 2011 Rhode Island Retirement Security Act. Last winter, after denying the state's motion to dismiss the cases, the presiding judge ordered the two sides to mediation.

Passive, or index investment management services, can be purchased by institutional investors for 1 basis point (one one-hundredth of a percent) or even "for free."[10] Active managers, who attempt to beat the market by stock-picking, may charge pensions fees that are 100 times greater (1 percent). Alternative investment managers, including hedge, venture and private equity, may charge asset-based, performance and other fees amounting to approximately 8 percent-- 800 times greater fees than indexing.

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

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

"State pension funds, including Maryland, have succumbed for years to a popular Wall Street sales pitch: "active money management beats the market." As a result, almost all state pension funds use outside managers to select, buy and sell investments for the pension funds for a fee. The actual result — a typical Wall Street manager underperforms relative to passive indexing — is costly to both taxpayers and public sector employees.

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

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

billion in fees annually, while obtaining similar (or better) returns to those of active managers."[11]

It is well established that sponsors of public and private retirement plans have a fiduciary duty to ensure that the fees their plans pay money managers for investment advisory services are reasonable. Fees paid for such retirement plan investment services have always been an important consideration for ERISA retirement plan fiduciaries. Further, in recent years such fees have come under increased scrutiny because of class action litigation, Department of Labor regulations, and congressional hearings.[12]

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.

[11] Wall Street Fees, Investment Returns, Maryland and 49 Other State Pension Funds by Jeff Hooke and John J. Walters, July 2, 2013. Rhode Island and two other states were excluded from this study, according to the authors, because they had not published Comprehensive Annual Financial Reports for fiscal years ending December 31, 2011 or later.

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

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

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

B. AFSCME Requests Disclosure of ERSRI Total Investment Management Fees

On January 10, 2013, Steve Kreisberg, Director of Collective Bargaining at AFSCME in Washington, DC, filed an ARPA request with the Office of the General Treasurer, requesting disclosure of all of the investment management fees paid to ERSRI's managers, expressed both in dollars and basis points.

In his response dated January 24, 2013, Mark A. Dingley, General Counsel/Deputy Treasurer indicated that the total dollar amount paid to ERSRI money managers as fees was included in each monthly State Investment Commission report viewable through the Treasury's website. (In fact, as explained more fully below, the monthly reports provided to the State Investment Commission and viewable on the website have misrepresented the level of fees.)

Remarkably, in this same ARPA response, Dingley indicated that his office would need to perform substantial research and analysis (for which AFSCME would have to pre-pay in the amount of $1,485.00) in

order to comply with Kreisberg's request to produce all documents showing investment management fees in basis points.[13]

Worse still, payment of the $1,485.00 fee by AFSCME, according to Dingley, "does not guarantee that the records you have requested constitute public records (in whole or in part, i.e., redacted), but only authorizes this office to conduct its search and retrieval to determine if responsive records exist, and if so, whether said records are public records."

AFSCME's Kreisberg reportedly responded to the letter he received from the General Treasurer's Office by saying, "That language was clearly written for a desired outcome and that was to deter us from following up on the request. These are public records—they want to gouge us to get them, if at all? I don't think so."

""What concerns me here is that this is a continuation of the ratcheting up of opaque investments not on the market, and we're not seeing exactly what's being paid to the fund managers who are orchestrating this," Kreisberg continued. "These types of records, including basis points, are generally widely-available. What's happening here is that we're being told what these funds are worth—by the people who are managing the funds, and this is not a good place to be.""[14]

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[13] This is remarkable because, in our professional experience, we have never encountered a state pension which did not have, in basis points, the fees paid to each investment manager readily available for investment consultants, staff and board members to reference in reviewing managers, including comparing fees between managers. Failure to disclose manager fees in basis points makes it far more difficult for fiduciaries and participants to monitor and assess the reasonableness of the fees.

[14] AFSCME Info Request on Money Managers' Fees Blocked by Raimondo, April 16, 2013, GoLocal Prov.

In summary, absent any assurance that the information in the public records requested would be provided, even if the $1,485.00 payment the Treasurer's Office demanded was made, AFSCME declined to pay for a response.

C. Treasurer Discloses $11.5 Million FY 2013 Projected Investment Management Fees

At the time of Kreisberg's request, the fiscal year 2013 projected investment management fees disclosed on the Treasurer's website indicated total investment management fees of **$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.

The lack of complete disclosure of total fees related to ERSRI's substantial (and rapidly growing) alternative investment holdings—most significantly the 20% performance fees—resulted in the fees of the pension, as disclosed, appearing to be far lower than they, in fact, were.

Absent disclosure of the massive performance fees related to alternatives (which, as mentioned earlier, are exponentially greater than the disclosed investment management fees charged by traditional managers), as well as other expenses, neither the State Investment Commission nor the participants in the Fund could possibly assess whether the fees paid by ESRSRI were reasonable.

D. Treasurer Claims Not To Know Fees Paid To Wall Street

In a rapid response to a widely-read April 4, 2013 Forbes article which noted ERSRI's escalating investment management fees and lack of full disclosure of the amount of such fees,[15] the Treasurer claimed in an interview on April 5, 2013, that she did not know the amount of the fees ERSRI paid to its investment managers. Despite her lack of knowledge, she assured readers that the undisclosed fees were reasonable:

"All the fees that we paid are industry-standard. So everything we're doing is in line with what we should be doing. And it is transparent… Look, you're always concerned to make sure that we don't pay excessive fees… But, again, everything we're investing in are brand-name firms with a proven track record – and we always get the best fees. In consultation with our investment advisers, we negotiate wherever possible to make sure that the state of Rhode Island receives among the best fees of other investors."[16]

Ironically, as part of her "Smart Money Tour," the Treasurer has urged seniors to be aware of fees on their bank accounts. "Always read the fine print," she warned.[17]

E. Treasurer Discloses To Providence Journal $33.1 Million In Hidden Investment Fees Paid By ERSRI To Alternative Managers In FY 2012

On April 25, 2013, the Providence Journal reported that the Treasurer's Office had provided the local newspaper with records showing that the state paid $15.8 million in fees to 19 hedge funds for the eight months ending June 30, 2012. The state paid $10 million to hedge funds in management fees and another $5.8 million in performance fees.

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[15] Rhode Island Public Pension "Reform" Looks More Like Wall Street Feeding Frenzy, Edward Siedle.

[16] Q&A: Raimondo fires back after Forbes contributor attacks her, WPRI.com.

[17] RI Treasurer Raimondo gives money tips to seniors, Pawtucket Times.

However, the office stated it could not immediately produce how much in fees had been paid since then, "given how the records are kept. Those fees aren't in the detailed monthly investment reports produced for Investment Commission meetings, because they are not directly billed to the state."[18]

During the same period (FY 2012), the Treasurer's office told the Providence Journal that the state paid $7.5 million in management fees plus $9.8 million in performance fees to managers of its private equity portfolio, a total of $17.3 million.

In summary, the Treasurer disclosed **$33.1 million** in hidden investment fees paid in FY 2012, which represented only an eight-month period for the hedge funds.

This disclosure of tens of millions in hidden fees paid by ERSRI in FY 2012 to investment managers by the Treasurer's office at this time was notable for the following additional reasons:

- First, recall the Treasurer had responded to the request by AFSCME (an organization that represented thousands of actual participants in the pension) for such fee information in January 2013, indicating it was not readily available and a search, which would not necessarily be fully responsive to the request, would cost AFSCME $1,485.00.
- Second, the here-to-for unavailable information regarded hidden fees was provided by the Treasurer to the Providence Journal (which has a reputation for supporting her) *for free*.[19]
- Third, since the fee information was provided to the Providence Journal exclusively and informally, as opposed to publicly

[18] Hedge Strategy Draws Criticism, Providence Journal.

[19] Telephone conversation with Mike Stanton, Providence Journal.

disclosed pursuant to a comprehensive APRA request for all relevant documents, there was no assurance that it constituted a complete or accurate record. Indeed, the fee information had not been audited.

- Fourth, if these millions in hidden fees related to alternative investments were not (as the Office of the Treasurer stated above), detailed in monthly investment reports produced for the State Investment Commission, then the State Investment Commission could not possibly, as fiduciaries, have monitored and determined whether the fees the pension paid to its alternative investment managers in FY 2012, were reasonable or excessive.[20]

F. State Auditor General Recommends Full Disclosure of Alternative Investment Expenses

On May 7, 2013, the Office of the Auditor General issued a report regarding ERSRI's internal control over financial reporting and the Auditor's tests of its compliance with certain provisions of laws, regulations and contracts.[21]

The report noted that ERSRI's FY 2012 "financial statements did not include investment expenses associated with hedge funds, and some private equity and real estate investments."

"The System's investment custodian is responsible for accounting for all of its investment transactions. The custodian provides various reports to the System which are used to

[20] In fact, the Providence Journal article quotes a long-time commission member stating that "she did not recall much discussion about fees when the commission elected to move money into hedge funds."

[21] Independent Auditor's Report On Internal Control Over Financial Reporting and On Compliance And Other Matters Based Upon An Audit of Financial Statements Performed in Accordance With Government Auditing Standards, Schedule of Findings and Responses Fiscal Year Ended June 30, 2012.

develop the System's financial statements. These reports indicated that investment expenses were nearly $12.7 million during the fiscal year ended June 30, 2012 and, accordingly, were recorded as such on the System's financial statements. This amount did not, however, include investment expenses associated with hedge funds, and some private equity and real estate investments. Hedge fund investments totaled more than $1 billion at June 30, 2012 representing 14% of the System's total investment portfolio. Investment expenses for these categories of investments were reported to, and by, the investment custodian as a net reduction to investment income.

Generally accepted accounting principles (GAAP) allow for presenting investment income net of related expenses on the financial statements when the expenses are not readily separable. However, that presentation, while not at odds with GAAP, does represent an inconsistent presentation among the various classes of investments.

We believe the System should attempt to separately identify such expenses whenever possible for enhanced transparency and consistency in financial statement presentation."[22]

As noted by the Auditor General above, since the investment expenses for ERSRI alternative investments "were reported to, and by, the investment custodian as a net reduction to investment income," the amounts of such fees must be known and readily available—contrary to repeated statements by the Treasurer.

G. Treasurer Discloses To Providence Journal $47.5 Million In Hidden Investment Expenses Paid By ERSRI In FY 2013

In an August 3, 2013 article, the Providence Journal reported that an analysis of hedge fund data provided by the Treasurer's office and confirmed by the state's private hedge fund consultant estimated that ERSRI paid **$45 million** in hedge fund fees in the last year (FY 2013), as well as **$2.5 million** in fund expenses.

[22] Id.

“In Rhode Island’s first 20 months in hedge funds, from November 2011 through June 2013, the state paid $61 million in fees — $16 million for 2011-’12 plus the estimated $45 million last year. In addition, the state paid $2.5 million last year in fund expenses.”[23]

Once again, this information was informally provided to the Providence Journal at no cost.[24] The $47.5 million in estimated hedge fund fees paid in FY 2013—related to only a small percentage (14 percent) of the ERSRI portfolio—already exceeded the entire amount of investment expenses subsequently disclosed for FY 2012, as discussed below.

H. Treasurer Finally Discloses $43.3 Million In Total Investment Expenses Paid By ERSRI in FY 2012

The disclosure regarding pension investment expenses on the website of the Office of the Treasurer has been modified significantly over the past six months in response to growing criticism. Today, in the Frequently Asked Questions (“FAQs”), the Treasurer admits that the investment expenses have increased but that “in return the portfolio has more diversification and less risk.”

The FAQ responses state that pension investment expenses are paid in two ways: “direct-billed” management fees that are reported to the State Investment Commission each month and “indirect” management and performance fees that *will* (emphasis added) be posted in conjunction with the Treasury Annual Report, generally published six months after the end of the fiscal year. (That is, in the future indirect fees paid by ERSRI will be disclosed to the public—for the first time ever.)

[23] Will Rhode Island’s big bet on hedge funds pay off? Providence Journal.

[24] Telephone conversation with Mike Stanton, Providence Journal.

The above disclosure makes it clear that while the State Investment Commission has recently approved a dramatic increase in the amount of ERSRI assets allocated to high-cost alternative investment managers, the SIC has not *ever* reviewed the total, i.e., direct and indirect, compensation ERSRI pays each and all of the investment managers it has hired.

As mentioned earlier, the State Investment Committee has a fiduciary duty to monitor ERSRI investment fees for reasonableness. Without complete information regarding fees paid, the SIC has not (and cannot) fulfill its fiduciary obligation with respect to review of investment fees.

Apparently, the exponential increase in fees (approximately 400% through FY 2012) related to restructuring the pension and hiring alternative managers was never brought to the attention of, or reviewed by, the SIC.

In the FAQs, the Treasurer continues to maintain that "only direct billed investment expenses are easily tracked." This is especially alarming since it is stated on the website that all of ERSRI's asset managers, except global equity and fixed income managers, i.e., the overwhelming majority, have indirect performance fees which, according to the Treasurer, are challenging to verify and report.

There are 76 ERSRI managers with performance fees, according to the Treasurer's website.

On the other hand, in the FAQs the Treasurer claims that there are many checks and balances to ensure that the alternative managers are deducting these indirect, difficult to track, fees properly:

Hedge fund returns, net of fees, are calculated monthly by third-party administrators who are responsible for monitoring Rhode Island investments. They

check valuations of the assets, as well as performance calculations. Additionally Cliffwater, the State Investment Commission's consultant, checks with funds on a monthly basis. On an annual basis the consultant reviews the funds' operations as do the funds' auditors. Investment division staff also looks at returns, fees and value on an annual basis, and for any asset managers that appear as outliers.

The total investment management fees for FY 2012 (as disclosed on the website) are stated as approximately **$43.3 million**. However, a footnote to the 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.

Since the purpose of disclosing expenses in public pension financial statements is to provide reliable information for participants, taxpayers and others (including SIC members), disclosure "for illustrative purposes only" is worthless. Further, with respect to ERSRI there is no need for illustrative disclosure since definitive information regarding these expenses—expenses which have already been paid – is readily available.

I. Treasurer Discloses $70 Million In Estimated FY 2013 Investment Expenses

According to published reports, preliminary numbers presented to the State Investment Commission on September 25, 2013, disclosed that ERSRI paid about **$70 million** in management and performance fees. Anne-Marie Fink, the state's Chief Investment Officer, said the state paid about $36 million in management fees and another $34 million in performance fees for the year that ended June 30, according to her

estimates.[25] The SIC was told that further information about investment fees will be disclosed at the December meeting.

In other words, the FY 2013 total actual fees paid by ERSRI have yet to be disclosed.

J. FY 2012 And FY 2013 Disclosed Investment Expenses—Still Significantly Understated—Approach $100 Million

Given the myriad fees related to alternative investments; the industry's lack of transparency and pervasive conflicts of interest, as well as the Treasurer's unwillingness to disclose total fees promptly, the ERSRI investment expenses for FY 2012, which over the past six months have been disclosed by the Treasurer as growing from $10.6 million; to $33.1 million; then $43.3 million, continue to be materially understated.

Further, the ERSRI investment expenses for FY 2013, which have been estimated by the Treasurer as growing from $11.5 million; to $47.5 million; then $70 million, continue to be materially understated.

For example, fund administration; interest on leverage; acquisition and disposition fees (including formidable securities trading costs) have not been included as expenses. These additional expenses combined can easily exceed 2 percent annually—in addition to the 2 percent asset-based and 20 percent performance fees—adding $20 million annually to ERSRI's already soaring disclosed annual investment expenses.

"Anyone who knows anything about hedge funds is aware that these private investment pools don't come cheaply. But the typical management fees of 1% to 2% of net assets -- plus 20% of the profits -- are often only part of the total tab. Add in extra charges for items such as audits, account administration, and trader bonuses,

[25] RI state pension fund earned 11.1 percent after paying $70 million in fees, Providence Journal.

and the average hedge-fund investor pays as much as 3.5% of assets a year, according to a recent study by LJH Global Investments, a Naples (Fla.) adviser to hedge-fund investors."[26]

In conclusion, the total investment expenses may already, or in the near future, amount to a staggering almost **$100 million** annually.

K. SEC Should Investigate Intentional Misrepresentation of ERSRI Investment Expenses

Estimating or projecting the investment advisory fees of a pension is a relatively simple matter, based upon manager fees schedules, asset allocation and investment performance. The Treasurer has had access to ERSRI data and staff, as well as outsourced investment consulting analytic services which have enabled her to know, or easily determine, the fees with a reasonable degree of certainty, as well as provide such information to the State Investment Commission for its review. Nevertheless, she has intentionally withheld from the public and the SIC information about the soaring fees which is material in assessing both whether ERSRI should invest in alternatives and whether benefit cuts are necessary to improve pension funding.

In our opinion, based upon our knowledge of pension investment operations, an investigation by state or federal securities regulators would reveal intentional misrepresentations and manipulation of ERSRI's disclosed investment expenses.

[26] A Fee Frenzy At Hedge Funds, Businessweek, June 5, 2005. Trading costs, which can be substantial, are not included in this estimate.

VII. ERSRI's Hedge, Venture, Real Estate and Private Equity Alternative Investments

A. High Fees Don't Matter, Only Investment Performance

According to the Composite Reporting Investment Valuation of ERSRI as of July 31, 2013, approximately $1.9 billion of the Fund's $7.73 billion in assets, or approximately 25 percent, was invested in alternative investment funds, including equity hedge funds; private equity; real estate and real return hedge funds.

Approximately $1 billion in assets in invested in 18 hedge funds.

While the Treasurer has yet to disclose the full amount of ERSRI's escalating investment expenses, she has stated (when questioned about hedge fund fees and transparency at a State Investment Commission meeting this spring) that she is "troubled by the fees. But my job is to maximize returns."[27]

In other words, if investment performance is superior, the high fees hedge funds charge are acceptable.

In April 2013, when questioned about the performance of ERSRI's hedge funds, the Treasurer responded:

"As you say, it's a young program, so it's early going – but we're pleased. So far the performance has exceeded the index by over 2% annually.

Over the last 10 years the state's private-equity investments have earned an annualized return that exceeds the S&P 500 index by 5%, and the hedge funds – again, early returns – but have exceeded the index by over 2%.

Q: Exceeded the S&P 500 Index or the hedge fund fund-of-funds?

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[27] Id at 24.

The hedge fund fund-of-funds."[28]

However, there is no proof that alternative investments beat the market. Indeed, possibly the world's greatest investor, the Oracle of Omaha, Warren Buffet, five years ago wagered $1 million that hedge funds would not beat the S&P 500 over the next ten years. At this point Buffet is still handily winning, as hedge funds returned an average of 5.5 percent in 2012 versus the almost 16 percent S&P gain.

Bloomberg Businessweek's provocative cover story "Hedge Funds Are for Suckers," on July 11, 2013 discussed reversals of fortunes involving many leading hedge fund managers. Further, the magazine noted that 8 of the last 10 years simple, low-cost index funds have outperformed hedge funds.

According to the authors of the Maryland Study cited earlier regarding state pensions:[29]

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

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

Complicating Private Equity performance measures is the fact that many leveraged buyouts from the pre-crash period have yet to sell, and the state pension systems

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[28] Q&A: Raimondo fires back after Forbes contributor attacks her, WPRI.com. While ERSRI does not invest in hedge fund of funds, it uses a Hedge FOF Index to benchmark its hedge fund investments. Due to the multiple layers of fees related to hedge fund of funds which reduce net returns, this index is inappropriate to use and far easier for ERSRI's hedge fund managers to outperform.

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

rely on the buyout funds' in-house valuation of such investments to determine the systems' own investment returns. The states exercise limited supervision over the buyout funds, and examination of buyout fund portfolio values by buyout fund independent certified public accountants is less than rigorous."

B. Investment Underperformance Doesn't Matter, Only Diversification And Risk Reduction

As the investment performance of ERSRI has continued to lag behind its peers under the new mix of assets adopted at the Treasurer's recommendation that relies more heavily on hedge funds,[30] the Treasurer has acknowledged that her new investment strategy could reduce the upside potential for ERSRI's investments. The Treasurer claims ERSRI will benefit over time because of a reduction in the risk and volatility of the pension's portfolio as a result of alternatives. In short, loss of upside return is acceptable as long as downside risk is reduced.

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

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

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[30] Rhode Island's $7.6-billion pension fund earned 11.07 percent during the 12 months ended June 30, according to Bank of New York Mellon Corp., the state's custodial bank. The median public-sector pension plan with assets of at least $5 billion earned 12.43 percent over the same period, according to Wilshire Associates. Hedge fund underperformance alone amounted to $100 million.

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

That's hardly diversification."[31]

Further, while the loss of upside return at ERSRI is apparent at this time, amounting to hundreds of millions of dollars, the amount of any potential downside protection afforded by the alternatives is unproven and unknown.[32]

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

C. Hedge Fund Documents Reveal Massive Risk, Fiduciary Breaches And Potential Illegalities

In order to determine whether the hedge fund investments owned by ERSRI lower the pension's risk, as the Treasurer has represented, we reviewed the offering memoranda related to many of these investments.[33]

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

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

[33] While the Treasurer has refused to disclose these memoranda and other documents related to the alternatives to the public, claiming that the documents contain proprietary business information, thousands of copies of these offering documents have been distributed by the funds' investment managers to existing and prospective investors, as well as influential intermediaries, such as investment consultants. As discussed more fully below, certain of the hedge fund offering memoranda indicate that investors will not receive complete information regarding investment strategies and portfolio investments. Thus, it may be that the Treasurer, in fact, has agreed to permit the managers to not provide any of the fundamental information we and others have requested regarding these investments.

1. **High Risk, Illiquid, Speculative Investments**

The Ascend Partners II offering memorandum and other offering documents related to ERSRI's hedge fund investments generally prominently state (in capital, bold lettering) that an investment in a hedge fund is speculative, involves a high degree of risk, and is suitable only for persons who are willing and able to assume the risk of losing their entire investment. The partnership interests offered are illiquid. No public market for the partnership interests exists and none will be developed.

In summary, the Treasurer's representations regarding the level of risk related to ERSRI's hedge fund investments are wholly inconsistent with the hedge fund managers' own words.

2. **Wide Latitude Regarding High Risk Investment Strategies That May Change At Any Time**

ERSRI's hedge funds generally disclose specific risks related to investment strategies they may pursue such as short-selling; investing in restricted or illiquid securities as to which valuation uncertainties may exist; leverage on a moderate to unlimited basis, as well as margin borrowing; options; derivatives; distressed and defaulted securities and structured finance securities. Further, the managers warn potential investors they generally expect the level of commission charges and other transaction costs to be high.

To make matters worse, the managers have wide latitude to invest or trade the fund's assets, and to pursue *any* particular strategy or tactic

deemed advisable by the manager—all without obtaining ERSRI approval.

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

3. Hedge Funds Provide No Assurance of Diversification

Since the managers may completely change their investment strategies at any time, there is no way ERSRI can ensure that the hedge funds are providing any diversification whatsoever. Each hedge fund manager is free to invest in the exact same securities, pursuing identical strategies, as ERSRI's other managers, including traditional managers. For example, all the hedge fund managers could invest in a single asset class, say cash, or a single stock, say Enron, at an inopportune time.

Indeed, as mentioned below, ERSRI apparently does not even know the hedge funds' current portfolio holdings. Thus, representations by the Treasurer that the decision to invest a significant portion of ERSRI's portfolio in hedge funds can be justified by the diversification they provide is, at best, based upon a lack of knowledge about hedge fund operations.

4. Conflicts Of Interest

The hedge funds generally disclosed myriad conflicts of interest involving the investment managers to the funds and others. For example, among other matters, the investment manager determines the

value of the securities held by the fund. Such valuation affects both reported fund performance as well as the calculation of the management fee and any performance fee payable to the manager. The investment managers are subject to a conflict of interest because they can profit from inflating values. Further, the performance fee structure creates an incentive to the investment manager to engage in speculative investments and thus a potential conflict with the interests of the investors.

5. ERSRI Agrees To Be Kept In The Dark, Grants "Mystery" Investors Licenses to Steal and Consents To Potential Nondisclosure Illegalities

In addition to such risks listed above, Brevan Howard states that "as is common with other hedge funds," it intends to withhold from investors detailed disclosure of the composition of its investment portfolios.

The Indus Asia Pacific Fund offering documents include the following disclosure: "In an effort to protect the confidentiality of its positions, the Fund generally will not disclose its positions to shareholders."

The Winton Futures Fund alarmingly states, "As the Investment Advisor's investment system is proprietary, the Shareholders will not have the objective means by which to evaluate its operation or to determine whether it is being followed. Further, the Shareholders may not have the ability to review the investment positions of the Fund."

In summary, the ERSRI fiduciaries have unconscionably consented to being kept in the dark, abrogating their duty to monitor and safeguard pension assets.

Even more deplorable, the hedge fund managers blandly state that they are not required to provide the same type or level of disclosure

regarding investments and strategies to all investors. Certain mystery investors may invest on terms that provide access to information that is not generally available to other investors and, as a result, may be able to act on such additional information (e.g., request withdrawal of their monies) that other investors do not receive.

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

Says the Indus Asia Pacific Fund, "… the Fund, in its sole discretion, may permit such disclosure on a select basis to certain shareholders if the Fund determines that there are sufficient confidentiality agreements and procedures in place.

Davidson Kempner states, "The Fund has entered and may enter into side letters and other agreements and arrangements with certain investors pursuant to which, among other things, an investor may receive reports and have access to information regarding the Fund's portfolio that might not be generally available to other shareholders. Such investors may be able to base their investment decisions, including, without limitation, redeeming their Shares from the Fund, on information that is not generally available to other shareholders."

The Ascend Partners Fund II elaborates, "The Partnership and the General Partner may from time to time enter into agreements with one or more Limited Partners whereby in consideration for agreeing to invest certain amounts in the Partnership and other consideration deemed material by the General Partner, such Limited Partners may be granted favorable rights not afforded to other Limited Partners or investors, generally. Such rights may include one or more of the following: special rights to make future investments in the Partnership

and/or the Other Accounts, as appropriate; special withdrawal rights, relating to frequency, notice and/or other terms; rights to receive reports from the Partnership on a more frequent basis or that include information not provided to other Limited Partners (including, without limitation, more detailed information regarding positions); rights to receive reduced rates of the Incentive Allocation and/or Management Fee; rights to receive a share of the Incentive Allocation, Management Fee or other amounts earned by the General Partner or its affiliates; and such other rights as may be negotiated between the Partnership and such Limited Partners. The Partnership and the General Partner may enter into such agreements without the consent of or notice to the other Limited Partners.

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

Worse still, the Brevan Howard fund goes on to state that it "may be constrained, or may find it unduly onerous, to disclose any or all such information or to prepare or disclose such information in a form or manner which satisfies certain regulatory, tax or other relevant authorities. Failure to disclose or make available information in the prescribed manner or format, or at all, may adversely affect the Partnership or the partners in the Partnership that reside in such jurisdictions."

In other words, investors in the fund are warned that its nondisclosure policies may violate certain applicable laws.[34]

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

[34] The Winton Futures Fund even lists public disclosure obligations, i.e., "involuntary disclosure," as a risk factor.

regulators. Again, the absolute discretion ERSRI has granted to certain managers amounts to a license to steal from the state pension.

6. Heightened Offshore Regulation And Custody Risks

The Indus Asia Pacific Fund is, and other ERSRI hedge funds may be, companies incorporated and existing under the laws of the Cayman Islands and regulated under that law. The Winton Futures Fund is incorporated under the laws of the British Virgin Islands.[35]

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

For example, recently three Louisiana public pensions which invested $100 million in a troubled fund managed by Fletcher Asset Management, have struggled in Cayman Islands courts to have the fund liquidated and recoup their investment. A Louisiana state legislative auditor criticized the investment practices of the three funds. The report found, among other issues, that the funds didn't adequately document whether they would be able to liquidate each investment in their portfolio at a fair market price and within a reasonable time frame.[36] (As mentioned earlier, hedge funds prominently want that they are illiquid.)

[35] "The Winton Futures Fund is a "Professional Fund" under the law of the British Virgin Islands. As a Professional Fund, the Fund is not subject to supervision by the BVI Financial Services Commission or a regulatory authority outside the BVI. Further, the requirements considered necessary for the protection of investors that apply to "public funds" in the BVI do not apply to professional funds. An investment in a professional fund may present a greater risk to an investor than an investment in a public fund in the BVI."

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

There is no evidence the State Investment Commission was aware of, or ever considered, the unique risks related to foreign regulation of hedge funds.

Since ERSRI's alternative investment assets are held at different custodians located around the world, as opposed to being held by ERSRI's master custodian, the custodial risks are heightened and should be considered by the State Investment Commission.

When a member of the SIC requested information regarding the names and locations of the ERSRI's hedge fund custodians recently, Anne-Marie Fink, the Chief Investment Officer responded, "we don't have a single document that lists all the funds and all the custodians."[37] Obviously, if ERSRI did not have such a document, then the SIC could not have ever reviewed the many different custodians for safety and soundness.

Weeks later, a list of custodians was prepared by ERSRI investment staff for the first time and sent to all board members. As stated by Fink, "We want you, as an SIC member, to have full confidence in the funds that you voted for. (I'm also sending this email to the rest of the SIC, since other board members may have similar questions.)"

This list of custodians, prepared by staff for the board to consider approximately a year and a half after the hedge fund investments had been made, did not include the location of the assets at the custodian—a significant risk factor.[38]

[37] Email from Anne-Marie Fink to Marci Reback, August 2, 2013.

[38] Email from Anne-Marie Fink to Marci Reback, August 13, 2013.

VIII. Myriad Fiduciary Concerns Regarding ERSRI Investment in Point Judith Venture Fund

A. Unique Risks Related to Incumbent Money Manager Becoming Chief Pension Fiduciary

In 2011, 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 as the General Treasurer of the State of Rhode Island with the financial backing of out-of-state hedge fund managers. This unprecedented state of affairs posed myriad unique risks to the pension, its participants and taxpayers which have not been thoroughly investigated or addressed. Essentially, there has been a coup—the foxes (money managers) have taken over management of the henhouse (the pension).

Further, a significant portion of the Treasurer's wealth and income[39] relates to shares she owns in two illiquid, opaque venture capital partnerships she formerly managed at Point Judith Capital—one of which she convinced the state to invest in on different, less favorable terms.

Unlike the state which paid millions for its shares in one of the Point Judith funds, the Treasurer was granted ownership interests in both of the venture capital funds for free, thereby diluting the state's interest in the one fund.

Worse still, the venture capital industry is noted for its lack of transparency and once the Treasurer assumed office she refused to

[39] According to published reports, Raimondo earned as much as $500,000 in capital gains from Point Judith Capital in 2012, dwarfing her state salary of $108,808. GOLOCAL PROV, Stephen Beale, May 2, 2013.

disclose virtually any information regarding the investment fund as to which she and the state remain co-investors.

Point Judith Capital, the Treasurer's former employer, is a firm which is substantially funded by Tudor Investment Corp., a multi-billion dollar private equity and hedge fund conglomerate controlled by the secretive billionaire Paul Tudor Jones.

In a very real sense, today Rhode Island's leading investment fiduciary is largely compensated by an out-of-state hedge fund investor—worse still, she is paid indirectly and secretly.

B. Point Judith Capital's Lack of SEC Registration and Regulation

Prior to becoming Treasurer, Raimondo had been a co-founder and partner in a small newly-established local venture capital firm with limited assets under management and limited investment performance track record—assets under management, portfolio holdings and investment performance that, even today, remain largely unknown to the public. Any representations regarding these material investment matters by the firm or Treasurer are unverified.

Not only is Point Judith Capital a small investment firm with limited investment history, it is involved in an industry—venture capital—which is noted for a profound lack of regulation and transparency.

Neither the firm nor Raimondo have ever been registered or licensed by the SEC as a securities broker, investment advisory representative or investment advisor. As a result, key information regarding the partners and the firm, such as assets under management, types of clients, asset-based and performance fees, disciplinary information and marketing arrangements is unknown to regulators and law enforcement, as well as the general public.

Hiring unregistered investment managers increases the risk to ERSRI. According to information provided by the Treasurer's office, Point Judith Capital is one of 18 largely private equity investment managers (out of 91 total investment managers) hired by ERSRI that is not registered with the SEC.[40]

C. Point Judith Capital's Limited Assets Under Management, Portfolio Holdings And Investment Performance Track Record—All Unknown

According to information we reviewed created by Point Judith Capital, the firm has managed $15 million in a fund, Point Judith Venture Fund I, since 2001 and $60 million in a fund, Point Judith Venture Fund II since 2006 or 2007. These assets under management amounts and fund inception dates have not been disclosed to the general public by the firm (only to potential investors) and whether they are accurate is uncertain.

Investors in the second fund, Point Judith II, included ERSRI which, according to published reports, in September 2007 voted to make a commitment of as much as $5 million. ERSRI and the Treasurer remain investors in the Point Judith II Fund. The firm has not disclosed the identities of any of the other investors in the second fund.

D. Point Judith II's Significantly Higher Fees

It is our understanding that Point Judith Capital is currently seeking assets for a third fund at this time and that the fee structure of the Point Judith funds is generally a management fee of 2.5 percent and 20 percent of profits.[41]

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[40] July 5, 2013 response by Office of the General Treasurer to our ARPA request dated June 20, 2013.

[41]Note, however, that a Power Point presentation by Point Judith Capital to ERSRI, provided in response to our APRA request, states that the terms of the Point Judith II fund provide for a standard

If true, the fees paid to Point Judith by ERSRI are ***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 is no reason to believe that the firm should have commanded a higher fee.

Significantly, at the time when ERSRI made the decision to invest $5 million in the Point Judith II fund, the firm's assets total under management with any investment performance history amounted to, at most, only $15 million in the Point Judith I fund—a fund which Point Judith Capital had managed for only 5 years.

Point Judith Capital early-on stated on its website that it was an early stage private equity firm investing in high growth companies in Southern New England. The firm did not profess to have any industry focus. By 2006 the firm stated on its website that it was focused upon communications, healthcare and information technology companies and had a strategic partnership with Tudor Investment Corp., "a leading alternative asset management group with over $15 billion under management."

According to published reports, Tudor became the lead investor in Point Judith Venture Fund II, with a $15 million commitment and also took an equity stake in Point Judith Capital, the adviser of the fund. [42] Details regarding Tudor's equity stake in Point Judith Capital, e.g. how much Tudor paid, for what percentage ownership and to whom are unknown.[43] Answers to these questions are required to assess the

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fee (2 percent average) and a carry (20 percent). Why ERSRI would pay a higher fee (2.5 percent) than the fee stated in the presentation (2 percent) is unknown.

[42] The Little State That Could, Institutional Investor, December 2012/January 2013.

[43] We were unable to find disclosure of any such an ownership interest in Tudor's Form ADV filings with the SEC.

scope and nature of the relationship between Tudor, Point Judith Capital and the Treasurer.

E. Treasurer's Reversal: Denial of Request for Records Regarding Point Judith Fund

As a result of the lack of virtually any public, verifiable information about Point Judith Capital and the Point Judith II fund's portfolio and performance, in an ARPA request dated June 14, 2013, we requested the following material information from ERSRI:

Please provide any documents related to the Point Judith II investment, including any marketing materials; consultant recommendations; annual reports; statements of portfolio holdings; valuations of portfolio assets; and performance summaries.

The response we received June 28, 2013 simply stated "Enclosed please find the Power Point presentation that was presented to the SIC and a synopsis of the quarterly returns. Pursuant to Rhode Island General Laws … annual financial audits, Cliffwater's private equity analysis, and partnerships agreements are not considered public documents."[44]

This response is utterly inconsistent with the Treasurer's prior public statements regarding the Point Judith II documents.[45]

In an April 5, 2013 interview,[46] the Treasurer was asked, "What were the returns like at Point Judith, and are the pitchbooks, portfolio holdings and investment returns available publicly from Point Judith?"

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[44] Note that this response does not indicate whether ERSRI actually possesses any annual financial audits of the Point Judith II fund or other documents requested. Thus, we do not know whether Point Judith has been producing and ERSRI has been receiving documents from the fund which are required to adequately assess its performance and operations.

[45] As mentioned earlier, the Treasurer's assertion that ERSRI investment agreements may withheld from public scrutiny has been challenged by four open-government groups in Rhode Island.

The Treasurer's response was: "The returns, all that stuff is ***public*** (emphasis added), so whatever they submit, just like any other private equity firm, whatever they submit on a quarterly basis would be ***public*** (emphasis added). They submit quarterly reports on their investment performance, and we have that and that would be ***public*** (emphasis added)."[47]

F. Without Tudor, Point Judith Proposal to ERSRI Would Have Been Uncompetitive

The redacted Power Point presentation or pitchbook provided to us by the Treasurer states that Point Judith Capital is an "emerging"[48] firm which has as a strategic partner, Tudor, "a leading alternative asset firm with over $17 billion in assets under management." It is also stated that Tudor has a large limited partnership investment in the Point Judith II fund.[49]

While Tudor's "proven track record over 20 years," is highlighted, with respect to Point Judith's track record it is simply stated that Point Judith I fund, which was then perhaps 6 years old, is "generating top second quartile performance" with a profitable early exit and the balance of the fund accelerating in value."[50]

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[46] Q&A Raimondo Fires Back After Forbes Contributor Attacks Her, Ted Nesi, wpri.com

[47] Id.

[48] "Emerging" asset management firms are generally defined as firms that lack the assets under management and performance track records of established firms. "Emerging" may also refer to minority or women-owned firms.

[49] The amount of Tudor's commitment to the fund apparently was disclosed in the Power Point presentation to ERSRI but has been redacted.

[50] Note that this unredacted representation was made in 2007—before the 2008 market meltdown.

There are representations regarding the investing and operating history of the "PJC Team," prior to joining the firm. Asset management firms lacking investment performance track records are prone to cite performance related to the professionals at the firm (as opposed to the firm itself) in their presentations to investors. However, such performance claims are not viewed as credible in the industry because of the difficulty in verifying the performance stated, as well as the individuals responsible for producing it.

It is stated that the "Tudor brand and expertise make PJC even more attractive equity partner" and that the "relationship (with Tudor) in first year is strong."

In summary, the Power Point presentation clearly reveals that Tudor's track record and expertise were paramount; absent Tudor as a strategic partner and investor, the Point Judith proposal to ERSRI would not have been competitive. Significantly, at this point in time Tudor's strategic partner and significant investor relationship with Point Judith Capital would have been only months old and untested.

G. Point Judith II Strikingly Divergent (+22 Percent To -16.7 Percent) Performance Claims

In the Power Point presentation provided by the Treasurer, the investment performance of the Point Judith I and II funds, as well as the performance of investments made by the professionals at the firm prior to joining Point Judith is presented. However, all such performance information has been redacted.

Thus, we do not know either the performance information provided by Point Judith to ERSRI in connection with the Point Judith II investment, or whether the information provided to ERSRI was, in fact, accurate. If inaccurate, the Treasurer's office may be withholding information from the public regarding potential violations of law.

Nevertheless, the Treasurer has made numerous public statements regarding the performance of the Point Judith II fund, as well as released summary performance figures which are strikingly divergent.

22 Percent Return: In an April 5, 2013 interview,[51] the Treasurer stated that the Point Judith II investment was reviewed for ERSRI by Pacific Corporate Group, the pension's private equity consultant at that time.[52] Further, the performance of Point Judith at that time was, according to the Treasurer, top quartile in 2007.[53]

"It's a strong performer. They've produced strong returns. It's still a little bit early. Those kinds of firms have a 10-year investment life cycle, so they're maybe halfway through the cycle," she said.[54]

The Treasurer went on to state, "As I suspected they have solid performance, a realized return of 22% – so a 22% realized return, but again, they're halfway through the fund. Early returns are strong, but like any of these private equity holdings, you have to wait until the fund is done to see how they've performed."

12 Percent Return*:* On April 9, 2013 it was reported that the Treasurer's spokeswoman provided a correction saying the Point Judith II fund "has

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[51] Q&A Raimondo Fires Back After Forbes Contributor Attacks Her, Ted Nesi, wpri.com

[52] However, the Treasurer has refused to provide documents which would prove whether PCG reviewed the Point Judith investment for ERSRI. As a result, it is also unclear whether PCG recommended the investment to ERSRI, or, tellingly, any of its many other pension clients in other states. Finally, as detailed later in this report, given that PCG received tens of millions in placement agent fees from money managers elsewhere, it is appropriate to question the integrity of the firm's recommendations here, as well as whether Tudor or Point Judith may have paid any compensation to PCG.

[53] Even if true, Point Judith Capital only had a track record of managing approximately $15 million in 2007—hardly enough to justify a $5 million commitment from ERSRI.

[54] Assuming the fund commenced in 2006 or 2007 (the Treasurer has stated both inception years elsewhere), the fund is seven or eight years old today—rapidly approaching the end of any supposed 10-year life cycle, as opposed to "halfway through the cycle."

a 12% return; 22% is the amount that has been cashed in." Obviously, there is a massive difference between a 22 and 12 percent return.

10.9 Percent Return: In a May 2, 2013 interview, the Treasurer's office stated that the Point Judith II had an annualized rate of return of 10.9 percent as of June 2012.[55]

6.2 Percent Return: On October 10, 2013, the Treasurer's office stated Point Judith II had an annualized internal rate of return of 6.2 percent.[56]

4 Percent Return: In response to our ARPA request for complete information regarding the Point Judith II fund, we received severely limited performance information which simply stated quarterly capital account values and internal rates of return.

Without a schedule of contributions and distributions and audited financials indicating the fund's portfolio holdings and their values, it is impossible to verify any of the Treasurer's claims regarding the fund's performance, or to independently calculate such performance with any certainty. However, based simply upon the incomplete data provided, it appears that the annualized returns are significantly less than the 22 percent, 12 percent, 10.9 percent or 6.2 percent represented by the Treasurer.

In fact, our best estimate of approximately 4 percent will compound to less than what has been delivered by the traditional equity markets due to the extremely high volatility. Furthermore, market investments would have involved significantly lower fees and risk than this venture capital investment.

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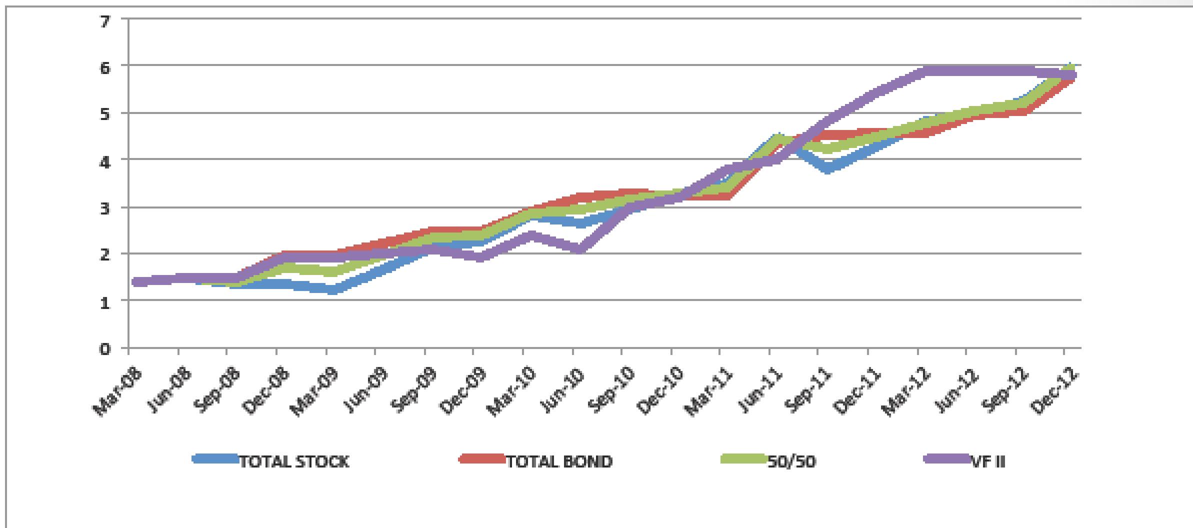
[55] Raimondo Receives Up to $500,000 Payment From Pt. Judith Firm, Stephen Beale, GOLOCAL PROV.

[56] State Pension Fund Pay $570,000 to Raimondo's Former Firm, GOLOCAL Prov

Performance of Point Judith Venture Fund II



-16.7 Percent Return: On July 12, 2013, summary data provided by the Treasurer to GOLOCAL PROV revealed that "in the four-year period the performance of the fund has been weak."The cumulative rate of return of the fund was calculated to be -16.7 percent by an expert commentator.[57]

H. SEC Should Investigate Point Judith II Performance

In conclusion, as a result of the Treasurer's refusal to disclose all of the material information regarding Point Judith Capital and the Point Judith II fund she formerly managed and marketed to ERSRI, choosing instead to disclose limited unverified information which is wildly inconsistent, it is impossible for the general public, participants and taxpayers to assess her and the firm's investment capabilities, as well as whether ERSRI should have ever invested, or should remain invested, in the Point Judith II fund.

[57] RI Pension Investment in Raimondo's Pt. Judith Had Steep Losses, Stephen Beale, GO LOCAL PROV.

This lack of full disclosure is especially problematic and of potential regulatory concern since it is our understanding that Point Judith Capital is soliciting investors at this time for a new investment fund. To the extent that any investment information regarding past performance of the firm, or its funds, is inaccurate, potential new, as well as existing investors in Point Judith Capital funds, may be misled.

In our opinion, in order to prevent any possible confusion or misleading of investors, it is appropriate to refer this matter to the SEC for investigation.

I. Rhode Island Ethics Commission Opinion Fails to Address Conflicts Regarding Point Judith Investment

On March 10, 2011 the Rhode Island Ethics Commission issued an Advisory Opinion in response to a request from the Treasurer dated January 11, 2011 for an opinion "concerning whether she had taken sufficient steps to avoid conflicts of interest under the Code of Ethics relative to her ties to a venture capital fund in which the state had made an investment."

All advisory opinions are binding on the Ethics Commission in any subsequent proceeding concerning the person or entity who requested the opinion and who acted in reliance on it in good faith, *unless material facts were omitted or misstated in the request for the opinion.*

Under the Code of Ethics, advisory opinions are based on the representations made by, or on behalf of, an official and are not adversarial, or investigative proceedings. In short, the opinion is utterly dependent upon the facts as stated by the petitioner.

In her letter to the Ethics Commission, the Treasurer represented that in 2007 the State Investment Commission entered into a ten-year contract with Point Judith in which the State agreed to invest five million dollars

in the Point Judith II fund over a period of time. She also represented that the State's investment in the fund was passive, meaning that after signing the contract with Point Judith and making its investment commitment, the State Investment Commission had no say in the fund's ongoing management or investment decisions. For that reason, she represented that it was highly unlikely that any matters pertaining to the fund or Point Judith would come before the State Investment Commission for any type of decision-making.

Nevertheless, recognizing a potential conflict between her role as Chairperson of the State Investment Commission and her association and investments with Point Judith, the Treasurer stated that following her election she resigned from Point Judith and from all management positions associated with the Point Judith funds. She retained, however, an illiquid ownership interest in both funds in the form of vested shares that she received in return for work she previously performed at Point Judith. In other words, unlike ERSRI, the Treasurer did not pay millions for her shares in the two funds.

In order to create further separation from her investment in the Point Judith funds, the Treasurer represented that prior to assuming office she placed all her right, title and interest in both funds into a blind trust designated as the Raimondo Blind Trust ("Blind Trust").[58]

The Treasurer notably failed to mention in her letter to the Commission that the state had not merely entered into a ten-year contract with Point Judith. Rather, the state was a limited partner in a fund managed

[58] I t is noteworthy that throughout the time she was seeking election, the Treasurer knew she had an ownership interest in an investment fund she had "sold" to ERSRI which was illiquid and presented a conflict of interest under the Code of Ethics of the state. Further, if after assuming office, the Ethics Commission had concluded it was impermissible for her to retain such an illiquid conflicted investment, there would have been few, if any, potential buyers other than Point Judith Capital partners, including Tudor.

by Point Judith as General Partner and, as a limited partner the state may have broad rights in the fund's ongoing management or investment decisions the exercise of which may conflict with her financial interests.

Historically, limited partners under the Uniform Limited Partnership Act of 1918 were passive investors and could not participate in control of the business and maintain their limited liability. In 1976, the Uniform Limited Partnership Act was revised to state that limited partners could participate in a safe-harbor list of activities that would not amount to participating in control of the enterprise. In 2001, a new version of the ULPA was promulgated which permits a limited partner to have whatever rights are stated in the limited partnership agreement. Thus, today a limited partner may have broad rights regarding management and investment decisions, as provided in the partnership agreement.

Further, as a Point Judith insider, she, or other investors, may have been granted special rights more favorable than those granted to the state, including special withdrawal rights; rights to receive reports from the partnership on a more frequent basis or that include information not provided to other limited partners; rights to receive reduced rates of the incentive allocation and management fee; rights to receive a share of the incentive allocation, management fee or other amounts earned by the general partner or its affiliates.

Since the Treasurer has refused to disclose documents related to the Point Judith II fund, as well as her and ERSRI's investment in the fund, the public cannot know whether permitting the co-investment to continue is harmful to the Fund. However, the characterization of the investment in the Point Judith II Fund as merely a ten-year contract in a passive investment as to which the state had no say is neither complete nor accurate.

With regard to the Raimondo Blind Trust, while a blind trust may be of value in certain circumstances, where, as here, the sole assets of the trust, i.e. the shares in the two Point Judith funds, are illiquid, i.e. cannot be sold for a decade, no protection is afforded. The purpose of the blind trust is to keep the beneficiary unaware of the specific assets of the trust, so as to avoid a conflict of interest between the beneficiary and the investments.

In this case, the Treasurer knows precisely the assets held in the Blind Trust during her entire term as Treasurer and continues to enjoy cash distributions related to the Point Judith funds—payments exponentially greater than her state salary in the past year— and payments related to shares she was granted for free.

Rather than provide protection against conflicts, here the blind trust serves to enable the conflict of interest involving ERSRI to persist throughout her term.

Most important, in connection with granting the Advisory Opinion, the Treasurer did not indicate and Ethics Commission did not consider that the Treasurer would subsequently refuse to disclose to the public information regarding ERSRI's investment in Point Judith II.

Ironically, the Blind Trust scheme she proposed to the Ethics Commission coupled with her nondisclosure policy regarding the Point Judith II fund, has resulted in only the public being "blind" as to the Point Judith II fund.

In short, in our opinion, this arrangement constitutes a misuse of the blind trust device.

IX. Conflicts of Interest Involving ERSRI Pension Consultant, Payments From Money Managers

A. SEC, GAO and DOL Investigate Pervasive Pension Consultant Industry Conflicts of Interest

As discussed more fully below, the investment consultant retained by ERSRI to review and recommend alternative investments, Cliffwater LLC, has disclosed in its regulatory filings with the SEC that it receives compensation from the very investment managers it recommends or selects for its clients. A conflict of interest arises under these circumstances because the consultant may recommend managers to the pension based upon such undisclosed compensation it receives, as opposed to investment merits.

In recent years the U.S. Department of Labor ("DOL"),[59] the Securities and Exchange Commission ("SEC"),[60] and the General Accountability Office ("GAO")[61] have each publicly acknowledged that conflicts of interest related to firms that provide investment services to pensions are widespread, and that these conflicts have resulted in reduced returns and higher fees for retirement investors.

Further, a new study by professors at the University of Oxford has concluded, perhaps for the first time that the investment consultants pensions rely upon for advice about which managers and funds in which

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[59] Selecting and Monitoring Pension Consultants, Tips for Plan Fiduciaries, U.S. Department of Labor, May 2005.

[60] Staff Report Concerning Examinations Of Select Pension Consultants May 16, 2005, The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission.

[61] Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges, GAO, June 28, 2007.

to invest— resulting in tens of millions of dollars in fees each year — are, as one of the authors of the survey says, “worthless.”[62]

B. Cliffwater Founder Leaves Wilshire Associates Amid Controversy

According to published reports, Stephen L. Nesbitt, the founder of Cliffwater, resigned from Wilshire Associates February, 2004, “after declining a reduction in responsibilities.”[63]

At this time, the nation was reeling from revelations of multiple scandals involving the mutual fund industry. Money Magazine stated that it had “learned that one of the world's leading investment firms -- Wilshire Associates of Santa Monica -- was engaged for years in massive rapid-fire trading of mutual funds that raises disturbing questions about ethics and conflicts of interest.”[64]

In addition to Wilshire's fast-trading scheme, which the SEC was looking into, a second area of investigation targeting several major investment consulting firms, including Wilshire, emerged at this time.

The variety of questionable payments from investment managers to consulting firms that were in a position to recommend them to their big institutional clients was described as "pay-to-play" arrangements. Wilshire was one of at least seven pension consulting firms that received a letter from the Securities and Exchange Commission in 2004 as part of an examination of pension consultants' practices, compensation and disclosure.

[62] Doubts Raised on Value of Investment Consultants to Pensions, The New York Times, September 30, 2013.

[63] Nesbit Leaves Wilshire Associates, HedgeWorld.com, February 11, 2004.

[64] The Great Fund Ripoff, Money Magazine, September 22, 2003.

According to Pensions & Investments:

"Mr. Nesbitt quit after he lost the consulting post in a reorganization in which Julia Bonafede was named senior managing director of consulting. Mr. Nesbitt was offered the funds management position but resigned instead, and Michael J. Napoli Jr. was named managing director of that division. Funds management handles manager-of–managers outsourcing; private equity, including venture capital and leveraged buyouts; and hedge fund selection."

The restructuring was done by Chief Executive Officer Dennis Tito and the board of directors.

"In light of the SEC's recent focus on consulting firms, the Wilshire board determined that in order to strengthen the ethical walls and eliminate the possible appearance of conflicts of interest, it was necessary to separate the funds management and consulting divisions and have them headed by different executives," Mr. Tito said in an e-mail response to questions from Pensions & Investments.

The firm also has been swept up in the mutual fund market-timing scandal, with the SEC reportedly reviewing Wilshire's trading practices. The firm has said it has not violated any laws. "Wilshire was contacted by the SEC as a part of its investigation of the mutual fund industry and cooperated fully," Mr. Tito said."[65]

While Nesbitt represented in a September 25, 2003 letter to David Russ, Treasurer of the University of California that Wilshire used a double "Chinese Wall" to separate the firm's proprietary mutual fund trading from the selection of money managers it recommended to pensions, according to a highly critical study authored by Charles Schwartz, Professor Emeritus, University of California, Berkeley, Nesbitt himself was in charge of the two divisions at Wilshire that the Chinese Wall he referred to was supposed to separate.

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[65] Nesbitt Walks When Wilshire Takes Away Consulting Role: SEC probe spurs firm to separate consulting and asset management sides, Pensions & Investments, February 9, 2004.

C. ERSRI's Contract with Cliffwater Prohibits Money Manager Payments

Pursuant to an agreement dated April 4, 2011, Cliffwater LLC serves as the non-discretionary alternative asset class investment consultant to the Fund.[66] The contract between the Fund and Cliffwater states that the total annual compensation to Cliffwater of $450,000 shall be paid in "hard dollars," i.e., an annual cash fee. Further, the consultant is precluded from accepting any fees, commissions, or other forms of compensation from any other party or source, whether direct or indirect, in connection with or relating to its services under the contract.

The contract states that the consultant is a fiduciary as that term is defined and applied pursuant to ERISA and to other applicable state and federal laws and common law.

The contract states that the consultant agrees that it shall not directly or indirectly receive any benefit from recommendation or advice made to the client and shall disclose to the client (a) any personal investment or economic interest that may be enhanced by the recommendations made to the client, or (b) any situation in which the interests of the client may be in material conflicts with the interests of the consultant.

D. Cliffwater's Changing SEC Disclosures Regarding Payments Received From Money Managers

According to Cliffwater's current Form ADV filed with the SEC, up to 10% of the firm's clients are other investment advisers; up to 10% are investment companies; and up to 10% are insurance companies.

[66] While real estate is also included in the Fund's alternative investments, it appears that Cliffwater is the investment consultant with respect to the hedge fund, venture capital and private equity investments only.

While a significant percentage of the firm's clients, up to 30%, are involved in the money management business, facts relevant to evaluating the potential conflict of interest related to these payments, such as the percentage of the firm's revenues derived from these clients, as well as the identities of and the services provided to these managers, are not disclosed in Cliffwater's SEC filing.

Prior to May 10, 2013, Cliffwater's Form ADV stated, "Other than for services provided to clients which are investment advisors, Cliffwater does not receive fees or any other compensation from investment managers or other service providers it recommends or selects for its clients." This disclosure language indicates that the firm receives compensation from investment managers or other service providers it recommends or selects for its clients.

Cliffwater's Form ADV was amended May 10, 2013 (apparently, as mentioned below, in response to questions we recently raised about the firm), to state:

"Cliffwater does not receive fees or any other compensation from investment managers or other service providers for fund selections and recommendations made to its clients. Separately, Cliffwater receives fees for its standard advisory services provided to a small number of clients who are investment managers that offer products and services to their investors. Cliffwater will advise a client in the limited instances where an affiliation exists between a fund selected or recommended for the client's portfolio and one of Cliffwater's investment manager clients."

This new disclosure language states that while Cliffwater receives compensation from money managers and may recommend or select investment managers who pay the firm compensation, any such fees or compensation received by Cliffwater from mangers is not *for fund recommendation or selection*.

Since Cliffwater's new SEC disclosure language indicates Cliffwater will advise a client where an affiliation exists between a fund selected or recommended for the client's portfolio and one of Cliffwater's investment manager clients, in our ARPA request dated June 30, 2013, we asked for documents related to any such disclosure by Cliffwater. ERSRI responded that its "internal reviews have not revealed any such claims."

In conclusion, Cliffwater's disclosed receipt of compensation from money managers it recommends or selects (regardless of whether any such compensation is, in Cliffwater's opinion, in exchange for any recommendations or selections), requires that a pension fiduciary relying upon the firm for independent advice regarding investment managers review any such compensation arrangements and evaluate any potential danger to the pension.[67]

As mentioned below, ERSRI has not required Cliffwater to disclose the sources and amounts of its manager compensation and has not evaluated the potential harm to the pension related to such payments.

E. Treasurer Fails To Provide Information Regarding Money Manager Payments to Cliffwater

As a result of the potential conflicts of interest related to compensation derived by Cliffwater directly and indirectly from investment managers generally, including but not limited to the Fund's managers, and the potential harm to the Fund related to any such payments, in our ARPA request dated June 30, 2013, we asked the Treasurer for additional detailed information regarding such payments.

[67] Due to the difficulty of monitoring and evaluating such conflicted payments, many prudent fiduciaries require that the investment consultants they contract with receive no compensation from investment managers.

Included in our list of questions for Cliffwater were the following:

"Do you or any related company receive any compensation from any investment advisers or any other service providers? If so, please name the advisers or service providers from which you or any related company receive compensation, as well as the amounts you or any related company receive from each of these investment advisers or service providers.

Are there any instances where your company has disclosed an affiliation that exists between a fund selected or recommended for the Fund's portfolio and an investment manager that pays any compensation to your company or any related company? If so, please provide the relevant disclosure documents.

Do you or any related company receive compensation from any investment companies? If so, please name the investment companies from which you or any related company receive compensation, as well as the amounts you or any related company receive from each of these investment funds or companies."

The Treasurer's response to our ARPA request did not include any of the detailed information we specifically requested regarding the identities of the managers, the amount of the payments and any services provided by Cliffwater to the managers.

Rather, the Treasurer summarily stated, "Cliffwater has clarified that in an abundance of caution, they listed compensation that they receive from insurance companies that have an ownership interest in money management firms on form ADV. Moreover Cliffwater has confirmed that they do not recommend to clients the firms they receive compensation from."[68]

As noted below, Cliffwater has admitted to a trustee of another public fund that Brown Brother Harriman, a firm which has been a private

[68] If this were true, then any money manager making payments to Cliffwater would do so knowing such payments would preclude the firm from ever being recommended for hire by Cliffwater.

equity manager since 1989 (and which is not an insurance company), makes payments to the firm. Brown Brothers Harriman manages approximately $272 million for the ERSRI.

Moreover, the Cliffwater SEC Form ADV disclosures (both earlier and current versions) indicate, contrary to this statement by ERSRI, that Cliffwater does indeed recommend managers from which the firm receives compensation.[69]

F. Other Cliffwater Representations Regarding Money Manager Payments

At a May 22, 2013 meeting of the State Investment Commission, when asked by Committee member Marcia Reback whether Cliffwater received any compensation directly or indirectly from any hedge fund, Nesbitt of Cliffwater stated that the firm did not. Reback then asked why Cliffwater reported to the SEC that they did. Nesbitt explained that they report to SEC that they may receive compensation from insurance companies that have an ownership interest in money manager firms.[70] He said they have never received any compensation from any hedge fund.

Recall that Cliffwater advises ERSRI regarding both hedge funds and private equity; Nesbitt's statement to Reback regarding receipt of manager compensation did not address any compensation derived from private equity managers.

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[69] As mentioned earlier, Cliffwater's current SEC filing indicates that "Cliffwater will advise a client in the limited instances where an affiliation exists between a fund selected or recommended for the client's portfolio and one of Cliffwater's investment manager clients."

[70] Note: This statement by Nesbitt is inconsistent with the firm's most recent SEC filings which indicate up to 30% of the firm's clients are insurance companies, investment companies and investment advisers.

In an email dated June 28, 2013 to a trustee of another public fund which utilizes Cliffwater, a Cliffwater representative stated the following regarding the firm's receipt of compensation from investment managers:

"The statement that Cliffwater receives compensation from hedge funds it recommends is factually incorrect and was (we think) derived from an incorrect interpretation of language in Cliffwater's Form ADV filing.

As you may know, we provide advisory services to institutional clients, including some financial institutions that are themselves investment managers.[71] Examples include Brown Brothers Harriman and Principal Financial Group. The language we used to highlight this in our Form ADV Part 2A previously read: "Other than for services provided to clients which are investment advisors, Cliffwater does not receive fees or any other compensation from investment managers or other service providers it recommends or selects for its clients."

When we realized that the language may be misinterpreted, we revised the language to read: "Cliffwater does not receive fees or any other compensation from investment managers or other service providers for fund selections and recommendations made to its clients.

Separately, Cliffwater receives fees for its standard advisory services provided to a small number of clients who are investment managers that offer products and services to their investors. Cliffwater will advise a client in the limited instances where an affiliation exists between a fund selected or recommended for the client's portfolio and one of Cliffwater's investment manager clients.

The point being that we do receive fees as an advisor to certain financial institutions to provide our standard consulting services, but we do not receive compensation for recommending any funds. Further, we would disclose the fact that we have a business relationship with any firm that manages a fund that we recommended to a

[71] Note that this language does not limit compensation received by Cliffwater from investment managers to insurance companies, as stated by ERSRI.

client (i.e. we would disclose the fact that Principal Financial Group is a Cliffwater client if we were to recommend a Principal fund to any of our clients)."

G. ERSRI Failure to Investigate Cliffwater Conflicts

In conclusion, based upon its response to our ARPA request, it is apparent ERSRI has never asked Cliffwater for information necessary to evaluate potential conflicts of interest related to payments received from money managers.

In our opinion, any evaluation as to whether the payments Cliffwater receives from money managers may be considered compensation for recommending funds, or may otherwise pose a danger to pension clients of the firm, must begin with Cliffwater disclosing the names of the managers, the amounts of the compensation paid and the nature of the services provided by Cliffwater to those managers. ERSRI has never requested such disclosures from Cliffwater.

While the effort related to investigating any such conflicted payments to Cliffwater is minimal, the potential harm to the pension is enormous. Further, the dangers related to such conflicted payments can be easily avoided by utilizing, as many pensions do, an investment consultant that does not receive such compensation from money managers.

H. SEC Should Investigate Cliffwater Conflicts

As mentioned above, Cliffwater's substantial investment manager client-base, the firm's changing SEC disclosures and inconsistent statements made by representatives of the firm to public pension trustees constitute, in our opinion, "red flags." Given the SEC's past regulatory

focus on pervasive pension consultant industry conflicts of interest, we believe a referral for investigation by the SEC is warranted.

X. Placement Agent Abuses at ERSRI

A. Controversial Role of Placement Agents

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

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

The federal securities laws generally require that registered investment advisers, when employing the services of third party marketers, provide the client with a written disclosure document, commonly referred to as a "solicitation agreement," describing the terms of any compensation arrangement between the solicitor (or marketer) and the investment adviser, as well as "the amount, if any, for the cost of obtaining his account the client will be charged in addition to the advisory fee, and the differential, if any, among clients with respect to the amount or level of advisory fees charged by the investment adviser if such differential is attributable to the existence of any arrangement pursuant to which the

investment adviser has agreed to compensate the solicitor for soliciting clients for, or referring clients to, the investment adviser.[72]

In summary, the disclosure requirements related to investment advisor third party solicitation arrangements reflect the belief that the investment advisory client should be advised of the existence of the intermediary, the fees paid to the intermediary and whether he is paying a higher fee as a result of the intermediary.

In our experience, the SEC has required registered investment managers utilizing undisclosed solicitors to offer the public pension investors rescission of the investment and return of all fees paid. Thus, failure to disclose marketing intermediaries can have severe consequences for investment managers.

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

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

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

regarding “pay to play” schemes related to public funds have been widely reported in Illinois, New York, California, Ohio and New Mexico.[73]

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

Virtually all large public pensions employ one or more investment consultants to recommend managers to be hired and monitor the performance of incumbent investment managers. For example, as of April 1, 2011, ERSRI retained Cliffwater, LLC as its external investment

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

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

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

consultant for alternative investments at a fee of $450,000 per year. Prior to that time, as indicated below, PCG served as the Fund's investment consultant for private equity investments.

Institutional investors that retain investment consultants generally seek to avoid payment of placement agent fees, recognizing that the services provided by the intermediary are unnecessary or that the fees bear little relationship to the services actually provided.

Further, with respect to public pensions, there is the very real danger of "politicization" of the investment decision-making process whereby hiring decisions are made based upon factors other than the merits of the investments offered, such as the political connections of placement agents that managers have hired to represent them.[74] Such "pay to play" schemes involving placement agents may increase the fees paid to external managers.

As noted in a March 2011 Report of the CalPERS Special Review, "the excessive nature of some of the fees paid by CalPERS created an

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

environment in which external managers were willing and able to pay placement agent fees at a level that bore little or no relationship to the services apparently provided by the placement agents. *Moreover, the involvement of placement agents apparently led to pressure to accept external manager fees that may have been higher than they should have been (emphasis added).*"[75]

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

"… addressing the economic issues raised by placement agent-related activities is essential to making participants and beneficiaries whole for the harm that was previously caused. While CalPERS did not have contracts with the placement agents involved with its external money managers, those external managers did. There was, in our view, at least some obligation on the part of the external managers hiring placement agents to monitor whether the millions of dollars in fees they were paying were, in turn, corrupting internal processes at CalPERS.[76]

According to published reports, there have never been any charges of corruption or "pay to play" relating the investments of ERSRI.[77] Further, the Treasurer recently stated that no placement agent fees have been paid with respect to the pension's alternative investments.[78]

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

[76] Id.

[77] The Little State That Could, Institutional Investor, December 2012/January 2013.

[78] Q&A: Raimondo fires back after Forbes contributor attacks her, WPRI.com, April 5, 2013.

B. Treasurer Admits Payment of Placement Fees

In a Rhode Island Access to Public Records Act (APRA) request dated April 23, 2013, we requested copies of any documents or materials, including, but not limited to, correspondence, e-mails, contracts, invoices, and regulatory inquiries, related to any placement fees paid by any money manager retained by the ERSRI within the past ten (10) years. We also specifically requested any investment management contracts entered into by ERSRI which referenced compensation of any third party. In addition, we asked for disclosure, in dollar amounts, of the actual placement agent fees paid by the external investment managers of the ERSRI in the past 10 years, as well as to whom the placement agent fees were paid.

In response our comprehensive request, Counsel to the Office of the General Treasurer provided in a letter dated May 7, 2013, certain limited documents, at no cost, related to placement agent fees paid since January 2007. [79]

As discussed more fully below, these limited documents indicated that, contrary to the Treasurer's public statements, placement agent fees had, in fact, been paid in the past related to the Fund's investments. This is yet another example of the Treasurer withholding and

[79] With respect to our request for copies of the investment advisory contracts which reference compensation of any third party, we were advised that any contracts responsive to this request related to private equity contracts that may be protected by confidentiality provisions. Further, it was stated that since the Fund was required to seek approval before making any disclosures related to confidential information that may be included in its contracts with private equity investment managers, producing non-confidential documentation required substantial effort on its part, with an estimated cost of $285.00. Further, payment of this fee did not guarantee that the information would be provided.

misrepresenting information from the public related to ERSRI's investments.

On the other hand, in response to a subsequent ARPA request dated June 14, 2013, regarding placement agent fees paid for the period from January 2003 through January 2007,[80] we were advised that prepayment of a fee of $3,465.00 would be required for any information whatsoever.

That is, merely identifying the placement agent fees paid and to whom for the 2003-2007 would require a substantial payment; whereas for the post-2007 period, disclosure of names and amounts paid involved no cost and copies of the private equity contracts required only a modest payment.

In our opinion, the different responses and fees related to the different time periods are "red flags" which require further investigation. Accordingly, on September 20, 2013, AFSCME agreed to pay a reduced fee ERSRI requested for the information of $2,385.00.

C. ERSRI Response To SEC Placement Agent Inquiry

In response to our APRA request dated April 23, 2013, counsel to the Office of the General Treasurer indicated in a letter dated May 7, 2013, that the pension had received a confidential informal inquiry from the SEC on May 8, 2009. A ten-page attachment to the SEC's letter requested information regarding disclosure of unfunded or underfunded liabilities; disclosure of investment risks; payments and conflicts of interest; and internal controls at the pensions to ensure compliance with the federal securities laws.

[80] This information was requested in our original ARPA request but we initially agreed that the post-2007 information would suffice for purposes of the original response.

Section D. Payments and Conflicts of Interest, Question D.4 of the SEC's information request asked:

"In connection with the investment or management of any amounts held in any pension fund … has any person ever directly or indirectly paid a finders' or placement fee or other valuable consideration?"

If yes, details regarding the identity of the persons making such payments, as well as his or her SEC registration status; the identity of the persons receiving such payments, as well as his or her SEC registration status; the nature and amounts of the payments; the services performed in exchange for the payments and whether the payments were disclosed were requested.

According to counsel, the ERSRI Executive Director responded to the SEC's questions on June 11, 2009 and emailed answers regarding placement agents on August 7, 2009. A copy of the SEC's letter and attachment and certain incomplete documents included in the state's response to the SEC were provided to us. For whatever reason, the Treasurer's office also gratuitously stated that copies of the SEC letter and the state's responses were provided to the Providence Journal on August 18, 2009, as well as the Rhode Island Retirement Board and Rhode Island State Investment Commission.[81]

D. ERSRI Fails to Investigate Use of Placement Agents

The state's June 11, 2009 response to the SEC indicated in its opening paragraph that "responses made "to our knowledge" means to the actual knowledge of Mark Dingley, Esq., Chief Legal Counsel/Chief of Staff, Office of the General Treasurer, Frank J. Karpinski, Executive

[81] Apparently the Providence Journal did not report on the Fund's disclosure of placement agent payments to the SEC.

Director of the ERSRI and Kenneth Goodreau, Chief Investment Officer for ERSRI, *without independent investigation* (emphasis added)."

Given that the role and compensation of placement agents had become a highly controversial issue nationwide by 2009 and that the risks, as well as potential recoverable fees and damages related to placement agents were significant, the lack any meaningful fiduciary response, i.e., an independent thorough investigation, by ERSRI to the SEC inquiry was, in our opinion, inexcusable.

E. ERSRI Relies Upon Conflicted Private Equity Consultant For Placement Agent Advice

Rather than undertake an independent investigation, ERSRI relied upon advice provided by its private equity consultant, Pacific Corporate Group Asset Management. ERSRI paid PCG $400,000.00 annual to provide objective, independent advice regarding private equity managers.

ERSRI responded to the SEC inquiry stating:

"In those limited instances where placement agent fees have been paid, we have been advised that none of the fees were paid by ERSRI. Instead, all fees were paid by the General Partners of the Funds."

"Rhode Island's private equity portfolio is monitored by our private equity consultant PCG Asset Management. PCG is currently canvassing the general partners of our private equity investment to obtain the requested information which will be provided to the SEC after it is assembled."

"PCG … has advised the state that fees paid to placement agents are paid by the private equity fund and then offset against the management fees of the general partner and *have no financial impact* on the Rhode Island State Investment Commission (emphasis added). Townsend, Rhode Island's real estate consultant, advised that there were no placement agent fees paid on any of the four real estate

investments since the beginning of 2007 (beginning of the current administration)."[82]

In 2009, at the very time ERSRI was relying upon PCG for objective, independent advice regarding controversial placement agent fees under scrutiny by regulators and law enforcement, it was revealed in published reports (which were easily accessible to ERSRI), that PCG itself was embroiled in the nation's leading placement agent scandal.

CalPERS was investigating the relationship between a former CalPERS pension board member who was paid $17 million in placement agent fees by two private equity firms to help them win business from California's giant pension fund at the same time he was working for PCG. PCG was the firm advising CalPERS on those $1 billion investments in Apollo Global Management and Aurora Capital Group.

PCG, which had been under contract with CalPERS to provide independent advice on its investments for two decades, in addition to its consulting work, had an investment division that actively sought business from pension funds. The company maintained that the divisions operated independently and that as a result, the relationship did not pose a conflict of interest.[83]

"It is an extreme conflict," said Mercer Bullard, a securities law professor at the University of Mississippi and a former U.S. Securities and Exchange Commission attorney. Pacific Corporate Group is "evaluating the company Villalobos is working for and Villalobos is doing something for them that has a major impact on their bottom line."

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[82] This language suggests that some placement agent fees were paid related to real estate investments before 2007.

83 CalPERS probing investment advisor's ties to middleman, Los Angeles Times, December 21, 2009.

Bullard stated that CalPERS' hiring of a consulting firm with such a conflict is "essentially giving up on true due diligence before the process even starts."

Likewise, in our opinion, ERSRI relying upon PCG for independent objective advice regarding placement agent fees tainted the review before it began.

A few months later, CalPERS severed its relationship with PCG that had employed the former pension fund board member who was by then accused of fraud.[84] The SEC filed fraud charges against the former board member who had reportedly reaped at least $58 million in placement agent fees on April 23, 2012. [85]

ERSRI did not terminate its relationship with PCG until March 23, 2011. According to the minutes of the meeting of the State Investment Commission on that date, business challenges, loss of business and instability were cited as reasons for the change. No mention was made at the SIC meeting of the placement agent scandals involving PCG.

F. ERSRI's Failure To Subsequently Investigate And Recover Placement Agent Fees

Not only did ERSRI in responding to the SEC inquiry in 2009 fail to independently investigate and chose instead to rely exclusively upon an investment consulting firm that was publicly known to be involved in extensive placement agent activity—a highly conflicted advisor—the Fund has not in the years following the SEC inquiry undertaken any subsequent independent investigation to verify the full extent of any placement agent fees paid and related damages, or sought to even

[84] CalPERS cuts ties with Pacific Corporate Group, Los Angeles Times, October 12, 2010.

[85] http://www.sec.gov/litigation/complaints/2012/comp-pr2012-73.pdf

recover the known placement agent fees or consulting fees paid to PCG for objective, as opposed to tainted, advice.

Given that the advice the pension received from PCG was, at a minimum, conflicted and potential violations of law may exist, in our opinion, a subsequent independent investigation should have been undertaken.

ERSRI prefaced its responses to the SEC's questions with language to the effect that "Rhode Island has been advised by its private equity consultant PCG and the General Partner of the Investment Fund that no placement fees were paid *in connection with* RISIC's investment (emphasis added)." Since whether a payment has been made "in connection with" a given pension investment can be debated, the preferable manner of investigating any potential placement agent fees is to require disclosure of all such payments and then determine whether any abuses may be present.[86]

G. ERSRI Discloses Over $1 Million In Secret Placement Agent Fees

The following placement agent fees were disclosed to the SEC by ERSRI in 2009:

1. Fenway Partners Capital Fund III paid Mr. Marvin Rosen, Principal for Diamond Edge Capital Partners $262,500 (1.75 percent of the $15 million committed capital by Rhode Island);
2. Constellation Ventures III LP paid Diamond Edge Capital Partners, LLC $262,500 (1.75 percent of the total capital commitment in Constellation Ventures III by Rhode Island);

[86] See earlier comments with respect to payments received by Cliffwater, ERSRI's current private equity consultant from investment managers.

3. W Capital II paid Probitas Funds Group, LLC $$76,985.[87]
4. Apollo Investment Fund paid Diamond Edge Capital, LLC, $437,500 (1.75 percent of ERSRI's commitment).

In summary, $1,039,485 in placement agent fees were disclosed to the SEC by ERSRI, $962,500 of which were paid to Diamond Edge Capital Partners.

According to a 2009 article in Bloomberg News, Marvin Rosen is a "middleman with political ties," a former Democratic National Committee finance chairman.[88] The Diamond Edge firm and certain of its other politically-connected employees (e.g., Glen Roger Sergeon) has been prominent in placement agent controversies nationally, including involving pensions in Kentucky and New York.

According to Forbes, "Diamond Edge Capital Partners is another firm that was paid–$6.8 million–by money managers for lining up work with New York. In 2008 Sergeon joined Diamond Edge, where he teamed up with Marvin Rosen, a company partner and the former Bill Clinton fundraiser who arranged Lincoln Bedroom sleepovers for big donors. Later that year Sergeon landed Diamond Edge its first business with Kentucky."[89]

Worse still, the largest placement agent fee disclosed to the SEC, $437,500, was paid to Diamond Edge related to an ERSRI investment in the Apollo Investment Fund VII. As noted earlier, PCG, the Fund's private equity consultant, had been paid millions in placement agent fees by

[87] Prior to joining Probitas Partners, Kelly Deponte was Chief Operating Officer and Managing Director at PCG.

[88] How Pension Placement Agent Exploited Political Ties, May 18, 2009.

[89] Secret Agent, May 23, 2011.

Apollo and clearly was familiar with Apollo's investment funds. **There was absolutely no need to pay anyone to introduce PCG to Apollo.**

The apparent impropriety of the substantial fee paid to Diamond Edge for "assisting in securing ERSRI's commitment to invest in the Apollo" fund should have been investigated immediately upon disclosure, due to the well-known allegations of wrongdoing regarding payments from Apollo to PCG.

In conclusion, while the General Treasurer recently publicly stated that there were no placement agent fees paid related to ERSRI, the documents which have been released to us to date indicate that at a minimum over $1 million in such fees have been paid to date. Since ERSRI has failed to undertake any independent investigation of placement agent abuses to date, choosing instead to rely upon past advice from a highly-conflicted former private equity consultant, **it is highly likely, in our opinion that additional fees were paid in the past that remain undisclosed by ERSRI.**

Most important, when the hiring of pension investment managers has been corrupted by undisclosed influential intermediaries, the potential resulting damages related to years of subsequent investment underperformance generally exponentially exceeds the amount of such improper payments. Recovery of any investment underperformance damages, which are likely to be substantial, should also be investigated.

H. Unanswered Questions Surrounding ERSRI's Current Practice and Policy Regarding Placement Agent Fees

The May 7, 2013 letter from the Office of the General Treasurer mentioned above responding to our ARPA request also stated that "no placement agent fees have been paid during the current administration of General Treasurer." The Treasurer provided, at no cost to us, copies

of Placement Agent Disclosure Certificates signed by the Fund's investment managers and consultants selected by the Fund after the date of the Fund's response to the SEC which purport to certify that no placement agent fees were paid to any third party placement agent with respect to the Fund's investments with each manager.[90]

The form of Disclosure Certificate signed by the managers has been modified by the individual managers. Further, a limited review of the Placement Agent Disclosure Certificates provided reveals significant concerns. For example, the Braemar Energy Ventures Certificate and the Summit Partners Credit Fund LP Certificate have been modified to warn that the Fund "acknowledges and agrees that the General Partner makes no representation with respect to any private equity advisor, third party marketer, placement agent or individual engaged, retained or paid by the investor with respect to the Fund's investment in the Partnership, including Cliffwater LLC and its affiliates." It is unclear why these managers included such language in their Certificates.

Nordic Capital discloses that it pays a placement agent an undisclosed fee for marketing its products in North America but states that no placement agent fees have been paid "in connection with the purchase by the Fund of its interest in the Partnership."

In conclusion, since the Treasurer has refused to provide any partnership and subscription agreements or other documents we have requested which reference payment of any such placement agent fees, the representations in the Disclosure Certificates that have been publicly

[90] The Certificates specifically state, "Notwithstanding anything to the contrary in the Partnership Agreement, the Subscription Agreement, or this Disclosure Certificate, the General Partner agrees that the Fund may disclose the information contained in this Disclosure Certificate to the public. Public disclosure of these Certificates is in stark contrast to the Treasurer's refusal to disclose other information regarding alternative investment Partnership and Subscription Agreements which contain far more information that is material to participants in the Fund, as well as taxpayers and bondholders.

disclosed (for free), are, at a minimum incomplete, should not be relied upon. Again, it is highly likely additional fees were paid in the past that remain undisclosed by ERSRI.

XI. ERSRI Substantial Illiquid Alternative Investments

According to ERSRI's Composite Reporting Investment Valuation dated March 31, 2013 approximately $1.9 billion of the Fund's $7.6 billion in assets or 25 percent was invested in alternative investments which "*are illiquid* (emphasis added) and may not have readily determinable market values"

A. Illiquidity Disclosure In Financial Statements Materially Altered

Following the initial article in Forbes discussing the risks related to ERSRI's illiquid investments as disclosed by ERSRI,[91] the disclosure regarding illiquidity of the assets in the valuation reporting of the Fund was materially altered.

The Composite Reporting Investment Valuation of the Fund dated April 30, 2013, indicates that approximately $1.9 billion of the Fund's $7.7 billion in assets or 25% is invested in alternative investments *which have varying degrees of liquidity* (emphasis added) and may not have readily determinable market values.

In other words, at least some of the alternative investments which were formerly regarded by ERSRI as illiquid are now considered liquid or more liquid—apparently in response to public outcry regarding the Fund's

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[91] Rhode Island Public Pension 'Reform' Looks More Like Wall Street Feeding Frenzy, Edward Siedle, April 4, 2013.

substantial illiquid holdings as disclosed. Given that, as discussed earlier, ERSRI apparently does not receive disclosure of portfolio holdings from the alternative investment funds in which it invests in a timely manner, statements regarding the liquidity of such assets are unverifiable and potentially misleading.

XII. ERSRI's Substantial Valuation Uncertainties

As noted in the Fund's s Composite Reporting Investment Valuations, the 25 percent of the portfolio invested in alternatives may be valued based on appraisals only, as opposed to readily determinable market values.

Notes to the financial statements of the Fund indicate that it relies upon the general partners of these alternative investment funds to estimate the fair value of the partnership investments. As stated in the financials:

"Because of the inherent uncertainty in the valuation of privately held securities, the fair value may differ from the values that would have been used if a ready market for such securities existed, and the difference can be material."

Further, it is stated:

"Fair value is the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller – that is, other than a forced liquidation sale."

In a forced liquidation, under the best of circumstances, ERSRI would likely experience a significant discount. In times of market stress, forced liquidations often occur at discounts as high as 50 percent or more. In other words, this almost $2 billion in risky alternative assets might only be worth half, $1 billion, at a time when the pension most needs the liquidation proceeds.

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

Contrary to prudent practice for pensions, no one in Rhode island is checking to see if the managers, who have an incentive to inflate the values of the portfolios they manage (since their compensation is based largely upon such values), are telling the truth. Further, ERSRI admits that the values assigned to these holdings do not reflect the values the fund would receive upon liquidation. ERSRI does not disclose how much less these holdings might be worth.

About Benchmark Financial Services, Inc.

Founded in 1999, Benchmark Financial Services, Inc. has pioneered the emerging field of forensic investigations of the money management industry and has conducted investigations worldwide involving in excess of $1 trillion in assets under management.

Benchmark was founded by Edward Siedle in 1999. The media has referred to Siedle as "the Sam Spade of Money Management," "the Financial Watchdog" and "the Pension Detective." He began his career in law with the SEC's Division of Investment Management, which regulates money managers and mutual funds; he later served as Legal Counsel and Director of Compliance to Putnam Investments, one of the largest international money management firms. Since 1989, Siedle has founded and managed firms offering specialized services to municipalities, pension funds and money managers.

He is nationally recognized as an authority on investment management and securities matters. He has testified before the Senate Banking Committee regarding the mutual fund scandals and the Louisiana State Legislature regarding pension consultant conflicts of interest. He was a testifying expert in various Madoff litigations. Articles about him have appeared in publications including Time, BusinessWeek, Wall Street Journal, The New York Times, Barron's, Forbes, the Boston Globe, and Institutional Investor. He widely lectures and has appeared on CNBC, Fox Business News, Wall Street Week, and Bloomberg News.

Siedle writes a "Financial Watchdog" column for Forbes.com He is also an active member of the Florida Bar and a retired member of the Massachusetts Bar.