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THE HONORABLE CURTIS M. LOFTIS, JR.
State Treasurer

April 9, 2013

Patrick J. Maley
Inspector General
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Dear Mr. Maley:

Since the current State Treasurer took office in January 2011, the State Treasurer's Office (STO) has noted many red flags regarding the five defined benefit pension plans that make up the South Carolina Retirement Systems (together, SCRS). These red flags primarily concern the South Carolina Retirement System Investment Commission (RSIC), which is the state-government agency that has the exclusive authority to invest and manage the assets of the SCRS, and sometimes concern the Public Employee Benefit Authority (PEBA), a state-government agency that administers SCRS. RSIC is composed of seven (six prior to July 1, 2012) members, hires a Chief Investment Officer (CIO), oversees the state agency of about thirty-five employees, and makes investment decisions for a highly diversified and global investment portfolio that approximates $25 billion. *See* S.C. Code Ann. §§ 9-16-315, 9-16-340. These red flags indicate that potential wrongdoing may exist. Such potential wrongdoing may include, but may not be limited to, public corruption, securities fraud and other violations of securities laws, mail and wire fraud, common law fraud, State ethics violations, and breaches of fiduciary duties.

STO has tried to follow-up on many of these red flags; however, key personnel at the RSIC often have stopped STO's inquiries (a) by wrongfully establishing and maintaining a cloak of secrecy around the RSIC and its activities, including, but not limited to, the valuation of alternative investments, the payment of investment management fees, the investment management agreements, and the travel and schedules of key personnel, or (b) by merely ignoring STO's inquiries, requests, or statements. Regarding the cloak of secrecy, certain members and senior staff of the RSIC staunchly fight to maintain the secrecy of their activities, and others in South Carolina government seem to support the secrecy by allowing the secrecy to continue. It is nonsensical that public servants would maintain such secrecy, especially when 58% of the SCRS' $25 billion portfolio is already invested in complex, non-transparent, illiquid, and high-fee alternative investments (Exhibit 39, p.1) and approximately 70% of the SCRS' investments are held outside of the custody of the State Treasurer and his designated custodial bank (Exhibit 29). It appears as though RSIC has no fear of any retribution for maintaining their cloak of

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secrecy, even with respect to co-fiduciaries of SCRS; ignoring STO's inquiries, requests, and statements; and violating applicable laws.

STO believes that this culture of secrecy and other red flags in a $25 billion public pension plan, which is already underfunded by approximately $16 billion, would be of interest to multiple law enforcement and regulatory agencies. STO is sending you this information because it also believes that one or more civil, criminal, or administrative investigations may need to be immediately initiated.

Because this letter and the accompanying exhibits are voluminous and because the Inspector General's Office may have subject matter limitations, **we have prepared a summary document that identifies the issues that are in this red flag letter** (and cross-referenced them to the applicable red flags) **in which your agency may be most interested**. However, we encourage you to read the entire red flag letter because we may have missed an item in which your agency may be particularly interested and because reading the letter as a whole will give you a better understanding of the environment in which SCRS operates. **The summary document immediately follows this letter**.

However, before STO lists and describes the red flags, STO will provide some context regarding SCRS and its major players. For many years, SCRS invested only in fixed income securities. In 1999, the SCRS began to invest in domestic equity securities. In 2005, RSIC was created, and it assumed all of the investing activities for SCRS. Shortly thereafter RSIC began to diversify SCRS into a wide range of securities, including foreign securities, hedge funds, private equity funds, commodities, real estate, debt instruments, and derivatives. *See* S.C. Code Ann. § 9-1-1310(B). Before 1999 and now, the STO is the statutory custodian of SCRS funds. S.C. Code Ann. § 9-1-1320.

Essentially RSIC is the investment adviser to the SCRS and, like an investment adviser, has a fiduciary duty to its client (i.e., the SCRS and its plan participants and beneficiaries). RSIC has the exclusive responsibility to manage and invest SCRS' assets. S.C. Code Ann. § 9-16-20(A). Accordingly, almost everything RSIC does seems to be in connection with the purchase or sale of securities. RSIC made the premature decision to diversify into complex alternative investments although it has never had the infrastructure to properly manage its diversified portfolio and the corresponding illiquid, complex, high-cost, and non-transparent alternative investments. RSIC maintains relationships with over 100 external investment managers across various asset classes and 13 strategic partnerships (*see* Exhibit 27, p. 5 n.3.) and buys and sells securities for its internally managed securities portfolios. Additionally RSIC's CIO, and possibly other RSIC personnel, serves on the investment committee of its strategic partners (*see* Exhibit 18, p. 7), so RSIC is integrally involved in the purchases and sales of securities by its strategic partners and its actions would therefore appear to be in connection with those securities transactions.

RSIC's rapid and extensive diversification into alternative investments has increased SCRS' overall risk because alternative investments are generally not held in custody by the State's statutory custodian; alternative investments consist of illiquid, complex, high-cost, and non-transparent

investment vehicles; and alternative investments create additional risks that are not present when investing in publically-traded stocks and bonds.

Also, co-fiduciaries exist within SCRS. (Exhibit 12, p. 17-18.) RSIC is a fiduciary to the SCRS and its beneficiaries and participants. The Budget and Control Board, the trustee of the SCRS, and the State Treasurer, the statutory custodian of the SCRS, are also fiduciaries. Until July 1, 2012, the Retirement Division of the Budget and Control Board performed many activities for SCRS, including preparing the annual financial statements of SCRS. As of July 1, 2012, the Retirement Division's duties were transferred to a new agency, PEBA, which is now also a trustee and fiduciary to the SCRS. *See* S.C. Code Ann. § 9-4-10; *see also* S.C. Code Ann. § 91-11310(A). Fiduciaries have duties to SCRS, the plan's participants and beneficiaries, and to co-fiduciaries. *See, e.g.*, S.C. Code Ann. §§ 9-16-40, 9-16-70; Exhibit 12, p. 18.

The red flags to which STO refers include the following:

1. Behavioral elements exist at RSIC that may identify a high risk of white collar crime.
    a. First, there are indications that key individuals lack a moral compass. For example:
        i. Chairman Reynolds Williams may mix his individual work as an attorney and title insurance agent with his fiduciary duties as a member of the RSIC as evidenced by the ongoing criminal and ethics investigations concerning his and his business associates' involvement in activities surrounding a $30 million real estate investment approved by RSIC and his statement that he must earn a living as he was discussing his role in that investment. (*See* Item 11a below.)
        ii. Allegations exist that key current and/or former persons associated with RSIC have engaged in questionable behavior when traveling on RSIC business.
        iii. When Chairman Williams made a false statement to the Budget and Control Board (the Board) in July 2012 and in front of all of the other members of the RSIC, none of the other members of the RSIC corrected Mr. Williams' statement. (Exhibit 25, p. 1-3; *see also* Item 8a below.)
        iv. When arguing against granting access to confidential information to the State Treasurer's staff at the July 12, 2012 Board meeting, the members of the RSIC and their staff conveniently omitted informing the Board that RSIC has already granted access to confidential information to staff of the Retirement Division (now PEBA). Although on October 29, 2011 RSIC entered into a Memorandum of Understanding (MOU) with the Retirement Division allowing Retirement Division staff access to confidential information (Exhibit 53), none of the members of the RSIC and none of its staff informed the Board of the MOU (*see* Exhibit 25). Of course, knowledge of the MOU by Board personnel would have been detrimental to RSIC's arguments in favor of maintaining its cloak of secrecy. Although RSIC continued to fight to restrict access to confidential information by staff of a fiduciary at the Board meeting, RSIC admitted in the MOU that controls existed, including Section 9-16-360 that established

standards of conduct for fiduciaries and their employees who handle confidential information, to protect confidential information held by a fiduciary or a fiduciary's staff. (*See* Exhibit 53, p. 1-2, 5.)

b. Second, the current Chairman and senior staff of the RSIC possess an arrogant attitude that has led them to by-pass or misapply existing laws and policies with little or no fear of retribution. (*See, e.g.*, Exhibit 4, p. 24; the discussion about confidentiality in Item 3 below; the discussion about the proposed creation of DEVCO in item 14 below.)

c. Third, the current Chairman and certain key RSIC staff possess the characteristics of cleverness and creativity with which they concoct schemes to ignore, obfuscate, or divert attention from key issues and existing problems or to create opportunities for personal gain. (*See, e.g.*, RSIC proposed creation of DEVCO, which would have been the first wholly-owned external fund manager of a U.S-based public pension plan, in Item 14a below; RSIC's incorrect application of clauses in contracts and S.C. law to protect its cloak of secrecy, as noted in item 3 below.)

2. Environmental elements exist at RSIC that may identify a high risk of white collar crime.

a. First, the organization is controlled by one man, Chairman Williams, who has been a member of the RSIC since its inception. His control seemed to exist even when he wasn't chairman. Like a close-knit family business, RSIC is run in a secretive manner and on a strict need-to-know basis. Fiduciaries are often wrongfully excluded from the need-to-know category, and, of course, STO staff is always wrongfully excluded for confidentiality reasons when such exclusion suits RSIC's purpose. RSIC manages Information and only shares it when necessary.

b. Second, a weak tone from the top of RSIC fails to establish an ethical fiber within RSIC. For example:

i. Key RSIC members and staff improperly withhold confidential information from fiduciaries and their staff. (*See* Item 3 below.)

ii. Chairman Williams and his law and insurance firms personally benefited from being involved in transactions concerning a $30 million real estate investment authorized by RSIC. (*See* Item 11a below.)

iii. In about 2009 RSIC created an Audit Committee, which did not meet for two years. (Exhibit 25, p. 10; Mr. Gillespie again referred to this failure to meet at the February 28, 2013 RSIC meeting.)

iv. RSIC did not disclose an $18.3 million overstatement of management fees for FY 2011 until the State Treasurer asked a question about the investment manager in question charging high fees. (*See* Item 23 below.)

c. Third, the control of RSIC from the top intimidates others and creates a vulnerable culture within RSIC. Some RSIC personnel are afraid to blow the whistle or even share information because they are fearful of losing their jobs. This fear is especially unique at RSIC because employees likely feel that they need to protect their jobs, which are unique financial services industry and high-paying jobs for South Carolina. RSIC pays some of the highest salaries in South Carolina state government and offers jobs in the

financial services industry that are not usually available outside of Wall Street and other national or international financial centers.

d. Fourth, within RSIC, compensation often outweighs ethics. For example, in the summer of 2011, Chief Investment Officer/Chief Executive Officer (CIO/CEO) Robert Borden's bonus would have increased by $65,000 to $70,000 if his salary increase was made effective on June 30, 2011, instead of July 1, 2011. In July 2011, the RSIC approved a salary increase for CIO/CEO Borden which was effective on June 30, 2011. When the members of the RSIC learned that Mr. Borden's bonus for FY 2011 would increase by $65,000 to $70,000 by making the salary increase effective on June 30 instead of July 1, the RSIC changed the effective date of Mr. Borden's salary increase to July 1, 2011. (*See* Exhibit 10, p. 1-4.) This manipulation of the effective date of a salary increase by one day seems consistent with the environment at RSIC where personal gain may outweigh ethics. After this result was brought to light and reversed in September 2011 (Exhibit 10, p. 4) and other questions were raised by the State Treasurer in September through November 2011 about CIO/CEO Borden's travel and calendar (Exhibit 11), Mr. Borden quickly resigned in early December 2011 (Exhibit 15).

3. To insulate RSIC, its questionable activities, and its complex, illiquid, non-transparent, and high-fee investments from others, RSIC has draped a cloak of secrecy over its activities by allowing Chairman Williams and RSIC's legal staff to misapply South Carolina statutory law and provisions in investment contracts (a) to prevent the State Treasurer's staff from reviewing and analyzing confidential information in an attempt to assist the State Treasurer in his various fiduciary duties and (b) to make it difficult for the State Treasurer to review and analyze the information by himself. (Please note that the same restrictions have been placed on other fiduciaries on the Budget and Control Board, including the Governor[1]; however, it is believed that those other fiduciaries rarely, if ever, request confidential information from RSIC and generally don't have a routine need for confidential information like the State Treasurer does.)

   On October 5, 2011, which was shortly after RSIC had denied some requests for information by the State Treasurer followed by the State Treasurer sending a FOIA request to RSIC (Exhibit 11), the RSIC requested an opinion from the S.C. Attorney General in an apparent attempt to provide RSIC support for withholding information from the State Treasurer. The Attorney General's opinion dated November 16, 2011, recognized that the State Treasurer has three fiduciary roles[2] to the SCRS and its plan participants and beneficiaries, that co-fiduciaries should keep other co-fiduciaries fully informed, and that co-fiduciaries should fully share information with other co-fiduciaries. (Exhibit 12, p.18.) Other than possibly affecting

[1] At the September 29, 2010 Budget and Control Board meeting, Governor Sanford made a statement about the RSIC's response to his request for information about a major issue. The Governor stated that the RSIC should not use a claim of attorney-client privilege to prevent disclosure of needed information to a fiduciary of the SCRS who is trying to gather information to perform his duties. (Exhibit 4, p. 20-21.)

[2] The State Treasurer's three fiduciary roles include being a member of the Board, being a member of the RSIC, and being statutory custodian of SCRS' funds. (Exhibit 12; *see also* S.C. Code Ann. §§ 9-16-10(4), 9-16-40.)

CIO/CEO Borden, who resigned two weeks after the Attorney General issued its opinion (Exhibit 15), the Attorney General's opinion did not have an impact on RSIC as it continued to protect its cloak of secrecy. After repeated attempts to gain access to so-called confidential information, the STO sought another opinion from the Attorney General, which STO hoped would change RSIC's mind about its secrecy. The Attorney General issued a second, similar opinion in 2012. (Exhibit 48.) The Attorney General concluded that all available information should be shared among co-fiduciaries of SCRS and "when in doubt, provide the information to fellow trustees." (Exhibit 48, p. 6.) Even after this second opinion, RSIC continued to breach its fiduciary duty by withholding information from its co-fiduciaries and their staff.

As stated earlier, Chairman Williams and RSIC legal staff routinely misapply South Carolina law and certain contractual provisions to withhold information from others. Particularly they misapply Sections 9-16-80 and 9-16-320(C) of the S.C. Code of Laws and contractual provisions in investment agreements to prevent the State Treasurer and his staff from seeing information that RSIC deems confidential.

a. Sections 9-16-80 and 9-16-320(C) deal with disclosures under FOIA and when an item can be discussed in executive session. Nowhere in these provisions does it state that a fiduciary and his staff cannot see confidential information. In fact, the statutory standards of conduct assume that a fiduciary and his staff may see confidential information by imposing a duty on them not to disclose confidential information. S.C. Code Ann. § 9-16-360(B)(7).[3] Regardless of this statutory burden placed in fiduciaries and their respective staff to maintain confidentiality, RSIC continues to treat fiduciaries and their staff as members of the general public regarding access to public records.
b. Additionally, it is believed that most, if not all, investment contracts do not prohibit access to confidential information by the State Treasurer and his staff.[4] It is believed that the contractual provisions limiting access are primarily directed at the general public (i.e., they are FOIA provisions) and often expressly allow the limited partner (i.e., SCRS), its affiliates, and its agents access to confidential information. (*See, e.g.*, Exhibit 60.) STO believes that a fiduciary to the SCRS and his staff would constitute being part of SCRS, the limited partner, or at least an affiliate or agent of SCRS.[5]

On January 30, 2012, the State Treasurer, his Chief of Staff, and his General Counsel asked to see information in a couple of RSIC's investment files. (Exhibit 20.) Upon arrival at RSIC on

[3] As noted in Item 1.a.iv above, RSIC used the standards of conduct imposed on fiduciaries and their staff to justify granting the staff of the Retirement Division (now PEBA) access to confidential information. However, RSIC and its legal team continued to refuse the State Treasurer's staff access to confidential information under the same statute.

[4] RSIC does not allow the State Treasure's legal counsel to review the investment contracts, so STO's legal counsel is generally kept in the dark about the contractual provisions that RSIC uses against STO to improperly justify its secrecy.

[5] Note that RSIC is not the limited partner or investor. In these investment agreements, SCRS is the limited partner and investor. RSIC is only one of several fiduciaries to SCRS.

February 3, 2012, RSIC legal staff insisted the State Treasurer and his senior staff members sign two confidentiality agreements before seeing any of the alleged confidential information. (*See* Exhibit 20.) After a long discussion, RSIC legal staff allowed the State Treasurer to inspect the files, but RSIC legal staff still insisted that the State Treasurer's senior staff members sign the two confidentiality agreements – one with RSIC and one with one of its strategic partners. The State Treasurer's senior staff members decided that the proposed confidentiality agreements were too onerous and did not sign them; hence, RSIC did not allow STO senior staff members to review the requested information.[6]

Subsequent to this February 2012 event, RSIC's legal staff and the Treasurer's General Counsel began negotiating a suitable confidentiality agreement. Before the negotiation was finalized, RSIC's Chief Legal Officer (CLO) informed the State Treasurer's General Counsel that then Chairman Gillespie informed RSIC's legal staff that RSIC's legal staff could not unilaterally negotiate the confidentiality agreement but must seek the full Commission's approval to do so.[7] The negotiation of a confidentiality agreement was then put on hold, although the issue of confidentiality began to be discussed in RSIC meetings and other venues (*see, e.g.*, Exhibits 22 and 25).

The events of early February 2012 demonstrated the RSIC-imposed policy that still exists today pursuant to which the State Treasurer alone is given access to some requested confidential information and must review and analyze the complex financial and legal information without any help from his own legal, investment, or administrative team. When the State Treasurer has reviewed certain RSIC files, he has found that RSIC sometimes does not provide him with the complete file and that RSIC treats as confidential many documents that are NOT confidential.

The documents that the State Treasurer is provided by the RSIC consist of tens or, many times, hundreds of pages. In addition to not allowing his staff to assist him in reviewing and analyzing documents, the RSIC places an undue burden on the State Treasurer by not allowing him to have a paper copy of the documents and giving him only online access to documents without the ability to print them. The State Treasurer has expressed to the RSIC the difficulty that he encounters by having to read and understand a long document in this manner. In some cases, this manner of access effectively eliminates the State Treasurer's review of critical contractual, legal, and otherwise material documents.

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[6] For comparison, RSIC's treatment of confidential information is 180 degrees different than the Budget and Control Board's treatment of confidential information. The Board treats the senior staff of a Board member (including the State Treasurer's Chief of Staff and General Counsel) as an extension of the Board member and shares confidential information directly with the senior staff of the Board member, knowing that Board members trust and rely on their senor staff for this purpose.

[7] It is believed that the RSIC has never voted to permit or deny access to confidential information to STO staff. The denial of access seems to be driven by certain members of the RSIC and RSIC's legal team.

After lengthy back and forth battles with the RSIC, the State Treasurer brought the confidentiality issue to the Budget and Control Board (the Board), the trustee of the SCRS, on July 12, 2012. (Exhibit 25, p. 1-13.) Although the Board undertook an analysis of fiduciary duties, the Board has taken no action to alleviate the problem, so the State Treasurer's staff is still prevented from seeing confidential information, and his access is still often limited to reviewing extremely long documents online.

On January 10, 2013, Chairman Williams sent a proposed confidentiality and non-disclosure agreement (the NDA) to the other members of the Commission. Although he did not seek the approval of the full Commission and has not formally presented the NDA to the STO, the NDA – once executed – supposedly would give staff of the STO some access to confidential information. The STO has taken it upon itself to review the NDA and found some serious weaknesses in it. Currently this NDA is being negotiated with the help of the Budget and Control Board's staff, although the members of the RSIC have still not approved its use. Sticky issues remain to be solved before STO's General Counsel can recommend that STO staff sign the proposed NDA. For example, RSIC still does not want to make all relevant investment files available for review. One of the types of files that RSIC does not want to make available are its due diligence files. Of course, RSIC may have a reason to prevent anyone from seeing its due diligence files. Consultants in 2011 and 2012 concluded that RSIC's due diligence files and procedures are very weak and, in some cases, are non-existent. (*See* Exhibits 9 and 27.) Additionally, RSIC's new Audit and Compliance Officer confirmed in August 2012 that RSIC's due diligence policies and procedures related to external investment managers "do not effectively mitigate the risks to the organization." (Exhibit 28.)

The extent to which RSIC has gone to protect its cloak of secrecy raises serious concerns. It is further concerning that RSIC uses this cloak of secrecy to restrict access to confidential and other information by fiduciaries and their respective staff (a) when Section 9-16-360 already imposes standards of conduct on fiduciaries and their staffs to protect confidential information and (b) when newer investments management agreements expressly grant access to STO staff.

Further, it is unusual that the legal opinion of RSIC's legal team regarding access to confidential information by STO's staff is fungible. This is especially true since RSIC's legal team is the group that negotiated all of the investment agreements that supposedly include provisions about confidential information and because RSIC legal staff should know the existing state law regarding the confidentiality of SCRS investment information better than anyone. However, their legal opinion appears to change frequently. For example:

a. In February 2012, RSIC legal staff first took the position that the State Treasurer and his staff could have access confidential information if they signed confidentiality agreements. (Exhibit 20.)
b. When pressed, they quickly abandoned their position that the State Treasurer, a fiduciary to SCRS, had to sign a confidentiality agreement.

c. Then, during the May 17-18, 2012 RSIC meeting, RSIC's CLO and its General Counsel made emphatic statements that State law does not allow the State Treasurer's staff to have access to confidential information even if STO staff members signed a confidentiality agreement. (*See* Exhibits 51, 52.) RSIC's CLO indicated that he believed that State law does not allow RSIC to grant STO staff access to confidential information. (*See* Exhibit 52, p. 187, 198-99.) RSIC's General Counsel is more emphatic. She said that the State statute dealing with confidentiality "specifically applies to Commissioners and Commission staff" and that "employees of other [state] agencies are not" specifically addressed in the statute. (Exhibit 52, p. 196-97; *see* Exhibit 51, p. 13.) Both attorneys fail to recognize or mention to their clients, the members of the RSIC, that Section 9-16-360(B) imposes standards of conduct on "a fiduciary or employee of a fiduciary" prohibiting the fiduciary and its employees from disclos[ing] or us[ing] confidential information . . . without proper authorization" and that violating this standard of conduct subjects the fiduciary and its employees to various remedial actions. *See* S.C. Code Ann. §§ 9-16-360(B)(7), (C). The General Counsel's stated opinion that Section 9-16-360 does not apply to other state agencies is in direct opposition to the MOU that RSIC entered into with PEBA which grants access to confidential information to PEBA staff and refers to Section 9-16-360 as justification for the action. (*See* Exhibit 53.)

d. After further pressure and the State Treasurer bringing the issue of confidentiality to the Budget and Control Board, Chairman Williams out of the blue sent a proposed NDA, which would supposedly permit STO staff to inspect confidential information,[8] to the other members of the RSIC. (Exhibit 43.) Of course, this NDA is not suitable because, for example, it withholds critical information from inspection.

The fungibility of the legal opinion of RSIC's legal team when combined with the legal team's emphatic statements in May 2012 that State law does not permit STO staff to have access to confidential information, while allowing PEBA staff to have access to confidential information, may indicate that the legal opinions of RSIC's legal team are being shaped by others (e.g., Chairman Williams) and are formed to limit access by the State Treasurer and to prevent access by his staff.

4. At least one limited partnership agreement (LPA) with a strategic partner of RSIC[9] may conflict with the terms of the investment that were approved by the RSIC. The LPA appears to commit SCRS to paying higher fees than the RSIC approved. The State Treasurer has informed

[8] Note that Chairman Williams' email does not mention access to confidential information by staff of the State Treasurer. It mentions access only by staff of a member of the Budget and Control Board and staff of a member of the RSIC. Even though the State Treasurer is a member of the Board and the RSIC, it is curious why Chairman Williams does not want to expressly state that staff of the State Treasurer as statutory custodian of SCRS' funds, a fiduciary to SCRS, is not explicitly being granted access.

[9] Please note that the LPA is not attached to this document to prevent allegations of any violation of confidentiality laws or contractual provisions and that the author of this letter has not seen that LPA for the same reason.

members of the RSIC about this situation on a few occasions, but STO believes that as of the March 2013 RSIC meeting neither the RSIC nor its staff have initiated an investigation or even asked for more information from the State Treasurer about the State Treasurer's concern.

Of course, STO staff could help the Treasurer either resolve his concern or provide the RSIC with detailed information about his concern if RSIC would allow STO staff to see alleged confidential information. Because of RSIC's cloak of secrecy, RSIC will not allow the financial and legal professionals on the State Treasurer's staff to inspect the LPA and other documents that would be necessary to confirm whether SCRS funds are being squandered.

In addition to squandering SCRS funds, the inclusion in an investment agreement of fees higher than approved by the RSIC and the execution of the LPA with such excess fees by a member of the RSIC (especially when combined with the RSIC's failure to act when informed) may result in an unlawful delegation of final investment authority to RSIC staff and the one member of the RSIC who signed the LPA. *See* S.C. Code Ann. § 9-16-30(A).

5. STO believes chairmen of the RSIC likely have been executing investment agreements without a proper review. For years, the chairman of the RSIC executed each LPA after it had been negotiated by RSIC's legal team. In many cases and possibly the vast majority of cases, once the LPA was negotiated RSIC staff merely sent the signature page of the LPA to the off-site chairman who did not review the entire LPA before he signed and returned the signature page. This lack of controls and complete reliance on RSIC staff to ensure that the LPA is proper in all respects creates an environment that is ripe for fraud. It allows numerous irregularities to occur and remain undetected. For example, see item 4 above where the terms of the LPA do not appear to match the terms approved by the RSIC.

6. On July 19, 2012, the RSIC adopted a policy concerning the approval process for new investments (Exhibit 46, p. 31-49; Exhibit 47, p. 3-4.), which the RSIC is now violating.
    a. Under the new policy, RSIC staff would bring an investment recommendation to the RSIC. The RSIC would then vote to grant tentative approval to the proposed investment and authorize RSIC's legal team to negotiate a final LPA. Once the LPA is negotiated, each member of the RSIC would be provided with a copy of the negotiated agreement and have 30 days to review and make an objection to the negotiated LPA. As the transcript of that RSIC meeting clearly demonstrates, the members' intent was for the RSIC to then take a second and final vote on the approval/denial of the newly proposed investment. After the second vote, the Chairman would be authorized to execute the negotiated LPA. (Exhibit 46, p. 36-37, 40.) Please note that, although the meeting transcript clearly demonstrates the RSICs intent to have a second vote, if the investment is approved, the actual motion made and approved did not mention a second vote. (Exhibit 46, p. 45.)
    b. However, Chairman Williams has imposed his own interpretation of the new policy by allowing members to raise an objection to the negotiated LPA during the 30-day

review period but also allowing himself to execute the new LPA without addressing the objection or having the second vote. The Chairman's misguided application of the RSIC's new policy results in a policy without any teeth and subverts the intention of the RSIC (i.e., essentially the 30-day review period by members is meaningless since the Chairman unilaterally chooses whether to act on any objection and has chosen to not hold a second vote on any new investment).

c. Recently the State Treasurer raised an objection to a proposed LPA during the 30-day review period; however, the Chairman executed the LPA anyway (and, of course, the Chairman did not resolve the State Treasurer's objection or call for a second vote). RSIC then directed the State Treasurer, as custodian, to transfer SCRS funds to the new investment manager. Because the State Treasurer did not believe that RSIC had followed its new approval policy of having a second vote (or at least resolving any objection to the LPA), the State Treasurer was concerned about funding an investment that had not been approved pursuant to the RSIC's own rules. Accordingly, the State Treasurer asked the Chairman to schedule a special meeting to address his objection (or to take the required second vote to approve the investment and override his objection) (*see* Exhibit 44), but the Chairman refused and executed the LPA. If the Chairman had called a short special meeting of the RSIC, the members could have resolved any misunderstanding or misapplication of the new policy. However, the Chairman acted unilaterally, violated at least the intent of RSIC's new policy, and refused to let a majority of the RSIC resolve the issues. Such action demonstrates the single-handed control exerted over the RSIC by Chairman Williams and raises the questions of why other members of the RSIC allow it to occur and why the Chairman exercises such high-handedness.

7. RSIC and its staff have been unwilling to remediate gaps in controls. In fact, they have taken actions that put SCRS funds at risk when they knew adequate controls were not in place.

   a. For example, although the State Treasurer has stated on a couple of occasions that the fees being paid pursuant to an LPA appear to be higher than the fees authorized by the RSIC (see item 4 above), as of the March 2013 RSIC meeting, RSIC members and staff have not taken any action or conducted any investigation to stop the possible unauthorized expenditure of trust fund money or to identify the extent of this type of irregularity.

   b. Additionally, in 2006 the RSIC began an aggressive diversification of its now $25 billion portfolio into foreign markets and complex, non-transparent, illiquid, and high-fee alternative investments without the necessary controls being in place. The initial diversification without sufficient controls was bad enough to raise serious concerns and violate fiduciary duties, but in seven years the RSIC still has not established sufficient controls to manage, monitor, and protect $25 billion of other people's money. It has continued to diversify since 2006 but still has not implemented many critical controls. No member of the RSIC or its senior staff appears to be prioritizing

the need to implement the necessary controls or to cut back on the risky diversification of the SCRS' portfolio until the controls are in place and verified.

i. RSIC members and former CIO/CEO Borden admit that they made and implemented a decision to make these investments without establishing the proper internal controls. (*See, e.g.*, Exhibit 10, p. 14 (Mr. Borden stating in September 2011 that "in 2005, the main priority was diversifying the Portfolio. The Commission was now seeking to build out its capabilities and infrastructure in a number of areas."))

ii. In 2010, CIO/CEO Borden admitted that the RSIC needed to build out its controls, but by that time RSIC had already invested $10.2 billion in alternative investments that needed a lot of due diligence and monitoring (both before and after the time the investment was made). Specifically, Mr. Borden informed the RSIC on September 23, 2010, "that the need to build out robust audit and risk functions is critical for a portfolio that is growing in sophistication and detail. He reported that a staff of 10 investment professionals is not appropriate for a $24 billion plan." (Exhibit 3, p. 4.) However, by June 30, 2010, RSIC had already invested $10.2 billion (33% of the plan's investments) in sophisticated and complex alternative investments. (Exhibit 2, p. 28, 42.)

iii. At the November 17-18, 2011 RSIC meeting, Dr. Rebecca Gunnlaugsson, Systems and Economic Specialist, reported to the full RSIC about the RSIC's current initiative "to build out the Commission's entire operational infrastructure" and referenced "a large number of findings in the Deloitte & Touche's Investment Risk Assessment." (Exhibit 13, p. 7.)

iv. Reports from outside professionals identify that the controls within RSIC to manage, monitor, and protect SCRS' assets have been and still are weak. (*See* Exhibit 1; Exhibit 9; Exhibit 27.) In the 2008 fiduciary audit, the outside professional noted that "Private i and Private Informant will be put into place" to monitor and measure alternative investments. (Exhibit 1, p. 24.) In 2013, RSIC still has not procured products similar to the ones recommended by the outside professional to monitor and measure alternative investments. In the 2008 report, the outside professional also raised the concern about the valuation of alternative investments approved by RSIC. (Exhibit 1, p. 24.) As demonstrated in item 22 below, valuation of alternative investments continues to be a material issue within SCRS, and it appears that RSIC never adequately addressed the valuation issue. In 2011, an outside consultant performed a risk assessment of RSIC's operations. At the September 15, 2011, RSIC meeting, CIO/CEO Borden stated that the deficiencies noted in the September 2011 consultant's report (Exhibit 9) should not surprise members because "while the Commission was no longer in the startup stage, there was still build-out occurring. He stated that when the Commission was formed in 2005, the main priority was diversifying the Portfolio. The Commission was

now seeking to build out its capabilities and infrastructure in a number of areas." (Exhibit 10, p. 14.) The 2011 consultants returned to RSIC in 2012. After the consultants concluded their 2012 engagement, their project leader verbally informed STO that the consultants could not examine any improvements made at RSIC since the September 2011 report was issued because RSIC hadn't made enough improvements. The consultants and RSIC staff therefore agreed that in 2012 the consultants would merely perform further analysis of three areas of RSIC's operations to make additional recommendations to the RSIC.

1. In its 2012 review, the consultants clearly stated that valuation of investments were still a major concern within RSIC. The consultant stated that RSIC "is ultimately responsible for the valuation of the investments reported in the plan's financial statements" and that it "should have sufficient information to evaluate and independently challenge the valuations use[d] by the External Managers," but the consultants' concluded that RSIC "currently does not maintain initial/on-going due diligence and financial controls to support the valuations of the External Managers." (Exhibit 27, p. 11-12.)
2. In its 2012 review, the consultants also stated that RSIC's due diligence programs were insufficient. The consultants noted that:
    a. RSIC has not consistently maintained or followed its own due diligence procedures;
    b. Thirteen strategic partnership files were missing one or more documents that the consultant expected to find in RSIC's files;
    c. RSIC said that it does not have the technology resources or staff to address its due diligence problems; and
    d. RSIC stated that its on-going due diligence procedures are not formally documented. (Exhibit 27, p. 8-9.)

v. In 2013, the necessary internal controls are still not in place. For example, in August 2012, RSIC's Audit and Compliance Officer confirmed that its due diligence policies and procedures regarding external investment managers and investment valuation "do not effectively mitigate the risks to the organization." (Exhibit 28.)

8. On at least two occasions Chairman Williams appears to have made material misrepresentations to other fiduciaries of the SCRS, the plan's participants and beneficiaries, the public, the taxpayers, and the General Assembly by stating in open public meetings that the necessary controls to protect the $25 billion trust fund are in place. This and other potentially fraudulent acts engaged in by Mr. Williams and others at the RSIC are likely made to influence legislators, the elected officials who appoint the members of the RSIC, taxpayers, beneficiaries, State employees, and others to allow the RSIC to continue to buy and sell the

alternative investments which are at the heart of a lot of the problems within SCRS. Accordingly, the fraud appears to be in connection with the purchase or sell of securities.

a. For example, at the July 12, 2012, Budget and Control Board meeting, Chairman Williams "emphasized that the Commission has successfully built out all of its internal controls in its oversight structure." (Exhibit 25, p. 2.) This statement is undeniably refuted by the consultant's reports in 2011 and 2012 (Exhibits 9 and 27); the RSIC's 2012 and 2013 budget requests in which it sought more funds to build out its internal controls; recent hires; Dr. Gunnlaugsson's comments during the November 2011 RSIC meeting about the need to build out RSIC's entire operational infrastructure and the large number of findings in the Deloitte report (Exhibit 13, p. 7); and other documents and actions. It also appears that Mr. Williams knew his statement was false when he made it. First, in 2010, Chairman Williams made a motion at an RSIC meeting to seek a significant increase in budgeted funds and full-time equivalent positions (FTEs) to address the critical need at RSIC for audit and risk functions and to add many more FTEs. (Exhibit 3, p. 4-5.) Second, Mr. Williams was present at the RSIC meeting at which CIO/CEO Borden stated the need to build out RSIC's infrastructure to meet the needs of its "sophisticated" portfolio. (Exhibit 3, p. 1, 4.) Third, Mr. Williams was present at the RSIC meeting in which CIO/CEO Borden referred to the findings in the consultant's September 2011 report and the corresponding need to build-out RSIC's infrastructure.

b. Chairman Williams also told the Senate Finance Committee on January 31, 2012, that controls and computer programs exist at RSIC to "spew out that information that's needed" regarding the custody of SCRS' investments. (Exhibit 19, p. 4.) Mr. Williams' statement is again easily refuted by the consultant's reports (Exhibits 9 and 27) and the RSIC's expressed need (and the nature of many alternative investments) to gather holdings information and other information on its non-transparent alternative investments.

c. In addition to the material misstatement, Mr. Williams' statement may have omitted a material fact because nowhere in his statement to the Senate committee did Chairman Williams inform the committee of the extent of RSIC's documented deficiencies in its control environment. (*See* Exhibit 19.)

9. Mr. Williams also appears to have made a couple of omissions of a material fact. First, at the November 18, 2011 RSIC meeting, he said he could not vote on the American Timberlands (AT) proposed $30 million investment in a limited partnership because his law partner "might" write some title insurance for AT in the future. (*See* Exhibit 13, p. 11.) He failed to disclose that one of his partners had already performed title (and probably legal) work for AT. Second, he failed to disclose the full extent of his and his partners' involvement in transactions related to the SCRS investment with AT a long time before the November 18, 2011 meeting. Failure to make these statements likely was an omission of a material fact and a breach of fiduciary duty. Third, Mr. Williams failed to inform the RSIC that his law and insurance firms have and would earn significant fees for their legal and insurance services to AT. See item 11 below for

additional information. These statements and omissions were in connection with the purchase of limited partnership interests by the SCRS.

10. As mentioned above, RSIC has inconsistent or nonexistent investment monitoring controls. See the consultants' reports. (Exhibits 1, 9, and 27.) Additionally, in a striking admission of incompetence, during the November 2011 RSIC meeting, former CIO/CEO Borden said that RSIC doesn't know what investments it owns.

11. RSIC lacks a clear process regarding conflicts of interest and has not taken adequate steps when a conflict has arisen.
    a. For example, Chairman Williams, his businesses, and his business associates appear to have benefited from his and his partner's involvement in a $30 million real estate investment authorized by the RSIC. Records demonstrate that Mr. Williams was involved in bringing the real estate firm to the RSIC and attended at least one meeting about the investment while one of his law partners performed legal and insurance services for the real estate fund in which RSIC decided to invest. Much of the legal and related title insurance work was done by Mr. Williams and/or his law partner before Mr. Williams withdrew from an RSIC vote to approve the investment because of a potential conflict of interest (*see* Exhibit 13, p. 11). Mr. Williams may have violated Section 9-16-360(B)(3) by receiving a benefit from a contract entered into by RSIC, Section 6-16-360(B)(6) by taking official action (e.g., introducing the real estate company to RSIC and attending an internal meeting about the potential investment) on matters that benefited himself, his family, or his business associates, and Section 9-16-360(B)(8) by using assets of SCRS for his own benefit. Although this situation was reported to the Attorney General's office and criminal and ethics investigations are ongoing by the Attorney General's Office and the State Ethics Commission, RSIC has not performed its own internal investigation, and Mr. Williams remains the Chairman of RSIC with the authority to execute investment contracts and to exert his high-handed control of the RSIC.
    b. CIO/CEO Borden usurped the authority of an investment committee consisting of RSIC staff to analyze and make a recommendation on the $30 million real estate investment referenced above. It is believed that Mr. Borden and Mr. Williams pushed this investment through to approval by circumventing standard operating procedures.

12. RSIC appears to breaching another fiduciary duty by failing to reconcile accounts and transactions in a timely manner. The best example of this is its failure to verify the amounts of management fees and performance fees before these fees are paid. In 2012, the State Treasurer questioned why the management fees paid to or earned by a particular investment manager in FY 2011 seemed too high. (Exhibit 7.) Within days and without acknowledging the State Treasurer's questions, RSIC staff reported to the members of the RSIC that the investment manager had overstated its fees for FY 2011 by $18 million. (Exhibit 8.)

The current procedure to verify or reconcile management fees is for PEBA's staff to verify "invoiced fees" (which approximated $55 million in FY 2012) before they are paid, but for RSIC staff to verify the so-called "netted fees" (which approximated $245 million in FY 2012) after the end of the fiscal year and, of course, long after most of the fees are paid. RSIC attempts to reconcile the netted fees of about $245 million after they are paid even though a significant portion of the $245 million of fees is known at the time they are paid and should be verifiable at that time. See Exhibit 40, p. 84-87 for documentation of the management fees that are "invoiced" and "netted."

13. Despite RSIC's rapid diversification into complex, illiquid, non-transparent, and high-fee alternative investments without first implementing the necessary controls and despite the findings in the reports by outside professionals in 2008, 2011, and 2012 documenting a need for such controls, the RSIC did not hire an Internal Auditor until 2012. Such hire, however, is insufficient because significant controls throughout RSIC are still lacking. Additionally, the use of an internal auditor as a primary control is not acceptable according to many financial executives and fraud experts.

14. Showing their arrogance, in 2010 key RSIC members and staff tried to create an investment management firm that would pay extraordinary salaries and would manage SCRS's illiquid private-market investments. The allocation to private market investments could approximate 24% of SCRS' portfolio. (Exhibit 3, p. 11.)
    a. In May 2010, CIO/CEO Borden presented to RSIC an idea to form a private company called DEVCO to manage the illiquid assets of the SCRS. DEVCO would be a wholly-owned subsidiary of SCRS. (Exhibit 62.) Showing RSIC's creativity and according to one Commissioner, DEVCO would have been the first wholly owned external fund manager of a U.S-based public pension plan.
    b. RSIC approved this proposal on September 23, 2010, and approved to give $15M in start-up money from SCRS to DEVCO, which Mr. Borden considered to be within RSIC's exclusive investment decision-making authority. DEVCO was to start on October 1, 2010. (Exhibit 3, p. 13; Exhibit 4, p. 27.)
    c. During the September 23, 2010, RSIC meeting, Mr. Williams called the DEVCO proposal "conceptually brilliant," said that "he sees no other way to consider the private markets program than by the creation of DEVCO," and made a motion to approve the DEVCO proposal. (Exhibit 3, p. 8, 9, 13.)
    d. The Budget and Control Board considered the DEVCO proposed on September 29, 2010. After the Governor's chief of staff asked RSIC for some information and did not receive it, the Governor stated that he received "a lawyerly letter" on September 28 from the RSIC saying that the RSIC did not know whether it was going to provide the requested information. On September 29, 2010, the Budget and Control Board stopped the transfer of SCRS assets to DEVCO. When stopping DEVCO, the Budget and Control Board was concerned with the issues of the RSIC moving too fast and the lack of transparency concerning DEVCO. The Governor also stated that DEVCO would pay

salaries of about $500,000 to each of 54 persons. The then State Treasurer said the RSIC acted with "arrogance." (Exhibit 4, p. 1-2, 18-27.)

15. RSIC has treated the State Treasurer, who is a fiduciary to the SCRS and a member of the RSIC, as a member of the general public regarding access to information so that it could maintain secrecy of certain information. In August and September of 2011, the State Treasurer wanted to see CIO/CEO Borden's calendar and documentation of his travel and entertainment expenses. Although he is a fiduciary and a member of the RSIC, which hires the CIO, the RSIC forced the State Treasurer to file a Freedom of Information Act (FOIA) request for these documents. (Exhibit 11; Exhibit 20, p. 6.) After RSIC answered at least two FOIA requests, the State Treasurer was still not satisfied with the extent of public records[10] that he received in response to his FOIA requests because, for example, the calendars that were provided did not allow one to determine CIO/CEO Borden's activities. (*See* Exhibit 16, p. 2-3.)

16. On December 2, 2011, CIO/CEO Borden abruptly resigned. (Exhibit 15.) This was about a year after the Budget and Control Board stopped RSIC's DEVCO initiative (Exhibit 4, p. 27-28) and shortly after the State Treasurer caused Mr. Borden's bonus to be reduced (Exhibit 10, p. 1-4) and shortly after the State Treasurer sought documentation of Mr. Borden's travel and entertainment expenses and calendar (Exhibit 11).

17. Although CIO/CEO Borden was making $350,000 to $485,000 per year (Exhibit 16, p. 2) and presumably could afford some luxuries, he lived a lifestyle in Columbia, S.C. that made him stick out like a sore thumb. He is still notoriously known as the one who drove around a relatively small Southern town in his yellow Lamborghini. (Exhibit 5.)

18. In addition to CIO/CEO Borden's abrupt resignation, the environment at RSIC seems to have problematic effects on other RSIC staff.
    a. As stated above in item 2, the intimidating tone from the top of RSIC has made some RSIC employees afraid to talk about the things they see and experience at RSIC. This fear extends to making rather innocuous statements about an RSIC employee's agreement with certain positions taken by the State Treasurer.
    b. Also, new employees in key positions at RSIC appear to be quickly resigning at an alarming rate. Over the last two years, RSIC has hired several people for key new or existing positions who have resigned within a short period of employment at RSIC. These new employees include Gary Li – Director of Risk Management and Asset Allocation (left RSIC in June 2012 after only 7 months of employment with RSIC and presumably did not live or work in South Carolina before or after his employment at RSIC) (*see* Exhibit 18, p. 8), Rebecca Gunnlaugsson – Systems and Economic Specialist (left RSIC about May 30, 2012 after being employed at RSIC for about 1 year), Tim

[10] Of course, as a fiduciary and member of the RSIC, the State Treasurer should have had access to more than "public records," which are available to the general public under FOIA.

Stevenson – Director of Risk Management and Assets Allocation (left RSIC after about a year of employment at RSIC), and Sondra Vitols – Senior Fixed Income Officer (resigned on February 11, 2013 after moving to South Carolina from Massachusetts and being employed at RSIC for only 6 months). (*See* Exhibit 50.)

19. In 2011, CIO/CEO Borden appointed an individual to the position of RSIC's Chief Legal Officer (CLO). (Exhibit 14.) This individual was not, and still is not, licensed to practice law in South Carolina. As CLO, this individual appears to practice law in South Carolina and direct the work of three other attorneys employed by RSIC and presumably the work of outside attorneys engaged by RSIC. STO understands that the CLO took the S.C. Bar exam in February 2013.

20. Beginning in FY 2008, RSIC chose to invest in 13 "strategic partnerships" (SPs) with major actors within the financial services industry. (Exhibit 18, attached Matrix; *see also* Exhibit 15, p.1; Exhibit 17, p. 2.) By January 2012, RSIC had committed $14 billion to these SPs, which is more than half of SCRS' entire portfolio. (Exhibit 18, p. 6.) However, many problems existed with these SPs, including the following:
    a. In many ways these SPs are more complex and less transparent than other alternative investments;
    b. They created conflicts of interest with certain RSIC members and staff;
    c. SPs use SCRS invested funds to pay for various costs, including travel and entertainment. (As reported in the Wall Street Journal on March 20, 2013, the SEC is "closely scrutinizing" these costs.);
    d. For at least the last couple of years, Chairman Williams appears to have been the sole member of the RSIC participating on the SP committee, when other similar committees have more than one participating member;
    e. Until December 2011, RSIC's relationship with each SP was managed by one employee, former CIO/CEO Borden; and
    f. Mr. Borden compared the SPs to the controversial and defeated DEVCO (Exhibit 3, p.6).

These SPs are non-transparent and multi-layered investments for SCRS. Mr. Borden referred to them as "free-formed allocations of capital." (Exhibit 3, p.6.) These SPs are limited partnerships (e.g., Apollo Palmetto Strategic Partnership, LP) between a financial services firm (e.g., Apollo Investment Corporation) and SCRS. SCRS becomes the sole limited partner in the SP owning a partnership interest of about 98%, and SCRS contributes all or substantially all of the capital to the SP. The SP then makes investments in other entities, which consist of a wide-range of complex alternative investments including private equity, hedge funds, real estate, commodities, debt, co-investments, and cash. Although the CIO of RSIC may be on the investment committee of most, if not all, of the SPs, RSIC either does not have or does not report to the members of the RSIC or other fiduciaries of the SCRS the underlying investments of the SPs. It is believed that once RSIC ensures that SCRS funds are transferred to an SP, the

SP has wide latitude regarding how it invests SCRS' contributions and may change asset allocations as the SP desires.

SCRS reports that the market value of RSIC-approved investments with the SPs at June 30, 2012 is $8.2 billion. (Exhibit 40, p. 78.) It is believed that some or all of the SPs pay expenses for RSIC and some of its members and staff which hides the true cost of operating RSIC and creates conflicts of interest between the SPs and RSIC's members and staff who take these benefits. A full accounting of the costs incurred by these partnerships is not available to a fiduciary like the State Treasurer. He asked for such an accounting of one of the SPs a few months ago, but his request was denied.

It appears as though RSIC exercises little control over the SPs. The 2011 and 2012 consultant reported that the RSIC does not have documented policies and procedures in place for SP oversight (Exhibit 9, p. 15) and that all 13 of RSIC's SP files were missing one or more documents that the consultant expected to be in RSIC's SP files (Exhibit 27, p. 9).

Shortly after CIO/CEO Borden abruptly resigned in December 2011, some members of the RSIC and others learned that no one, including NEPC – RSIC's investment adviser, other than Mr. Borden knew details about the SPs. After Mr. Borden's departure, a special project and many meetings were needed for other RSIC staff to gain a working knowledge of the strategic partnerships. (*See, e.g.*, Exhibit 17, p. 2; Exhibit 18, p. 1, 6-8.) It is further believed that, during this special project, problems with the SPs were uncovered causing staff to unexpectedly propose to eliminate about half of the SPs.

21. SCRS' financial statements appear to include a material misstatement by significantly understating the amount of investment expenses paid to third-party investment managers, including the managers of the SPs, which were selected by RSIC. If users of the SCRS' financial statements knew of the high fees being paid by SCRS due to RSIIC's decisions, many of those users may make different decisions. For example:
    a. New State employees may elect not to participate in SCRS because of the high fees and alternatively may elect to participate in the 401(k)-style retirement plan that is also offered by the State;
    b. Many users of the financial statements (i.e., retirees, taxpayers, the General Assembly, etc.) may decide that the average returns achieved by SCRS do not justify the high fees that RSIC has committed SCRS to pay;
    c. Many users may for the first time take a hard look at the complex, illiquid, non-transparent, and high-fee alternative investments in which significant conflicts of interest exist if those users knew the full extent of high fees being paid;
    d. Any of these situations, and others, could affect the way taxpayers vote, the manner in which legislators choose to oversee the RSIC and SCRS, the willingness taxpayers to support SCRS, and retirees' decisions about the safety of their pensions.

PEBA has taken responsibility for the financial statements of SCRS. As part of this responsibility, PEBA does not account for all management fees, performance fees, investment costs, and other investment expenses (together, Investment Expenses) similarly, which materially understates the actual amount being paid to the third-party investment managers. For example, in the FY 2012 audited financial statements of SCRS, PEBA reported Investment Expenses of $55,130,000. (Exhibit 39, p. 13, 46.) Although PEBA discloses in the notes to the financial statements that management fees paid to a "significant number of the alternative investment managers" are not recorded as Investment Expenses but are netted against the line item titled "Net appreciation (depreciation) in fair value of investments" (Exhibit, p. 39, p. 19), nowhere in these financial statements does PEBA disclose that, when adding the netted and undisclosed fees, total investment management fees for FY 2012 were $296,135,000 (*see* Exhibit 40, p. 87; Exhibit 24).

PEBA has elected not to disclose approximately $241,000,000 ($296K less 55K) of Investment Expenses in SCRS' financial statements for what appear to be a flawed and misleading reason. Although many of the fees not disclosed as Investment Expenses are known when they are paid, PEBA claims that netted and undisclosed fees of $241,000,000 "are not readily separable" from investment income and cannot be shown as Investment Expenses. (Exhibit 39, p. 19.) This statement is flawed and misleading because PEBA and RSIC know that many of the so-called non-separable fees are separately identified by the manager when the manager requested that these fees be paid. For example, managers whose fees are supposedly non-separable often identify the management fees on their written capital call requests. Additionally, RSIC has produced a schedule detailing all $296 million of fees, so the fees appear to be readily separable. (Exhibit 24.)

This material understatement of Investment Expenses occurred in FY 2011 too. In FY 2011, PEBA reported Investment Expenses of $71,050,000 (Exhibit 6, p. 36), when the actual Investment Expense approximated $325,326,918 (Exhibit 8), leaving an undisclosed amount of Investment Expenses of approximately $244,000,000.

Although PEBA's FY 2011 understatement of Investment Expenses could affect the decision of any user of SCRS' financial statements, STO knows that it negatively affected the Maryland Public Policy Institute (MPPI). MPPI produced a report dated July 25, 2012, in which it published the results of its review of the Comprehensive Annual Financial Reports (CAFRs) of the major statewide retirement systems for all 50 states to determine the ratio of fees paid by state pension plans to the applicable plan's net assets. (Exhibit 26, p. 1-2.) Because of PEBA's understatement of SCRS' Investment Expenses, MPPI used $71.05 million as SCRS' fees for FY 2011. (Exhibit 26, Appendix.) MPPI reported SCRS' ratio of Investment Expenses to net assets at 0.313% (Exhibit 26, Appendix), while the more accurate ratio was more than 4 times higher at 1.43% ($325.33 million divided by $22,691.66 billion).

Additionally, SCRS' Investment Expenses ratio of 1.43% in FY 2011 is extremely high compared to other public employee defined benefit pension plans in which the U.S. average Investment Expense ratio approximated 0.409%. (Exhibit 26, p. 2.) RSIC has been a party to certain agreements with PEBA regarding how and when Investment Expenses are accounted for and verified. SCRS' high, but undisclosed, ratio may lead some in RSIC to want to understate the amount of Investment Expense so that RSIC may confirm its high-fee investment program and continue to receive perks from Wall Street.

Please note that the SCRS' CAFR for FY 2012 (but not its FY 2011 CAFR) does include an unaudited schedule that discloses that total manager fees for FY 2012 were $296,135,000 (Exhibit 40, p. 87); however, PEBA did not disclose this amount in the audited financial statements which, as described above, materially understates Investment Expenses. Additionally, the unaudited disclosure of $296 million of fees is obscured by its disclosure on a 4-page schedule in the 210-page CAFR.

22. It also appears that the accuracy of the investment valuations used in SCRS' financial statements is in question because PEBA may not have performed its duty as "management" to ensure that the investment valuations were accurate. PEBA has assumed the role of "management" of SCRS. It also appears that PEBA and RSIC may have made materially false representations regarding the valuation of SCRS' investments at June 30, 2012.

As stated in item 21 above, PEBA has taken responsibility for the SCRS' financial statements and has assumed the role of management of the SCRS as documented by PEBA's Executive Director signing the audit engagement letter (Exhibit 23, p. 3) and its Executive Director and Deputy Director of Operations signing the representation letter to the auditor (Exhibit 38, p. 4). Accordingly PEBA, as management, has the responsibility to prepare SCRS' financial statements in accordance with GAAP. (Exhibit 23, p. 5; Exhibit 38, p. 1; Exhibit 39, p. 1.)

Although PEBA, as "management," has assumed responsibility for SCRS' financial statements, including the valuation of SCRS' alternative investments, the 2011 and 2012 consultant, which is also one of the world's largest CPA firms, stated that "the Commission is ultimately responsible for the valuations of the investments reported in the plan's financial statements, which SCRS prepares."[11] (Exhibit 27, p. 11.)

[11] Since STO believes that PEBA has little or no contact with the external managers who provide the valuations of SCRS' alternative investments and those investments constitute a material portion of SCRS' assets, it seems that RSIC should assume a more responsible role for SCRS' financial statements. Of course, the 2012 consultant also concluded that RSIC is not currently capable to validating the investments valuations provided by the external managers. (Exhibit 29, p. 12.) Therefore, PEBA's assumption of "management" responsibility for investment valuations does not seem to ensure that the proper party is responsible for investment valuations or that the proper controls exist to ensure that the valuation of each alternative investment is correct.

If PEBA (or RSIC, if applicable) fails to perform its duties as "management" to ensure that the investment valuations are proper, such failure may adversely affect the scope of the auditor's opinion on SCRS' financial statements. Any limitation in the auditor's scope may result in a qualified or adverse opinion on SCRS' financial statements from the auditor, which would not be beneficial to the SCRS or the State.

Part of management's responsibility for SCRS' financial statements is to ensure that each investment is properly valued at its fair value. (*See, e.g.*, Exhibit 38, p. 2; *see also* Exhibit 39, p. 1.) Although STO does not know if the valuations of the alternative investments used by PEBA are materially accurate, STO raised questions about whether PEBA met its responsibility as management to ensure the accuracy of the valuations. (Exhibits 30-33.) STO did not receive the documentation or confirmation that it requested from PEBA, but, based on the information that STO did receive, it still questions whether PEBA met its management responsibility regarding the investment valuations. Of course, if PEBA did not meet its responsibility in preparing materially accurate financial statements[12], the scope of the audit may require the independent auditor to issue a qualified or adverse opinion. (Exhibit 63, p. 2, 14-15.) In present case, the investment valuations are undeniably material to SCRS' financial statements, so STO believes that the auditor's scope would be limited if management did not meet its responsibility with respect to investment valuations.

In the FY 2012 audited financial statements, PEBA disclosed that investments are valued at "fair value" (Exhibit 39, p. 12, 19) and that the valuation of alternative investments is not precise and is particularly difficult to determine (*see* Exhibit 39, p. 19). As stated in the auditor's opinion, management has estimated the fair values of its alternative investments valued at $14.5 billion (or 58% of the trust fund's net assets) because these alternative investments lack readily determinable fair values. (Exhibit 39, p. 1.) Accordingly, it is reasonable to believe that PEBA has a lot of detailed and complex analysis to determine the applicable estimated value of each alternative investment.

Before the FY 2012 financial statements were issued, STO summarized its concerns and its understanding of PEBA's responsibility regarding the valuation of SCRS' investments in a letter to PEBA. (Exhibit 30.) In this letter, STO cited the AICPA's standard for management's responsibility regarding the determination of the "fair value" of alternative investments. The AICPA stated:

> Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its

[12] Note that PEBA stated on November 19, 2012, that it relied on RSIC's ongoing due diligence to represent to the external auditor that the investment valuations of alternative investments are accurate. (Exhibit 38, p. 2 – item 9.) Such reliance seems improper since in August 2012 (3 months before PEBA signed the representation letter to the external auditor) the 2012 consultant concluded that RSIC does not maintain initial or ongoing due diligence and financial reporting controls to support the valuations provided by external managers. (Exhibit 29, p. 12.)

> responsibility, management needs to *establish an accounting and financial reporting process* for determining the fair value measurements and disclosures, *select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuations*, and *ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.*

"Alternative Investments – Audit Considerations: A Practice Aid for Auditors," The American Institute of Certified Public Accountants, 2006, p. 4 (Practice Aid) (emphasis added) (Exhibit 63). The AICPA further stated:

> This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management. Although the investor entity's management may look to the fund manager for the mechanics of the valuation, *management must have sufficient information to evaluate and independently challenge the fund's valuation.*

Id. (emphasis added). As a directive to management, the AICPA continued:

> Taking responsibility for the valuation of the alternative investments will *necessitate that the management of the investor entity has a sufficient understanding of the nature of the underlying investments, the portfolio strategy of the alternative investments, and the method and significant assumptions used by the fund manager to value the underlying investments.* The nature and extent of management's process for valuing investments, and the related internal controls, are particularly important when the investor entity invests in securities for which readily determinable fair market values do not exist. In these instances, *management should have in place a process and internal controls over that process* to ensure that its alternative investments are recorded at amounts in accordance with its stated accounting policies.

Id. at 5 (emphasis added).

The AICPA then linked management's decisions to the auditor's procedures. Management may need to make critical decisions regarding the fair value determination of its alternative investments. These decisions by management directly impact the auditor's procedures and the veracity of the financial statements. "The more complex or illiquid the investment and/or the lack of sufficient management processes and records over valuation, the greater the risk of misstatement, and the more persuasive audit evidence that needs to be obtained by the auditor." *Id.* at 10.

Note that the 2011 consultant quantified RSIC' financial statement risk as "high residual risk[13]." (Exhibit 9, p. 7.) Therefore, the external auditor likely needs very persuasive evidence before giving an opinion on SCRS' financial statements.

The AICPA also mentioned some of management's duties when listing the internal control analysis that the auditor may perform. In accordance with AU section 319, *The Effect of Information Technology of the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, professional Standards, vol. 1), the auditor must gain an understanding of the internal controls sufficient enough to plan the audit. The auditor gains this understanding by performing procedures to understand the design of controls over financial reporting and determine if they have been placed in operation. Regarding valuations of investments based on fair value, the auditor may do the following when assessing internal controls:

- Consider management process used to determine fair value including accounting principles and valuation methods;
- Consider the availability of information used in determined fair value, including the *details of the underlying investments;*
- Consider the nature of the underlying investments, including the *complexity of investment strategies, the liquidity of trading markets, and the frequency of trading activity;*
- *Consider how management interacts with fund managers*, including the extent to which the fund managers enable management to estimate fair values at the balance sheet date;
- *Consider the competency and experience of the investor entity's personnel assigned to monitor and estimate fair values;*
- Consider the *availability of SAS 70 (now SSAE 16) reports* surrounding the controls and procedures in place at a service provider;
- Consider the use of an investment adviser to monitor the alternative investments and that factors that may affect the fair values; and
- Consider the availability of audited financial statements for the alternative investments and whether such statements are as of the same date as the investor entity's financial statements.

Id. at 8-9 (emphasis added).

Based on the auditor's analysis of an entity's internal controls, the auditor designs its audit procedures to provide reasonable assurance of detecting material misstatements to the financial statements. *Id.* at 10. The auditor's understanding of the reliability of the investor entity's internal controls affects the nature, timing, and extent of the audit procedures. *Id.* The audit procedures performed by the auditor may not be the same for all alternative investments because of the differing nature of each investment, the differing risks, and other factors. *Id.*

[13] The 2011 consultant defines residual risk as the exposure or vulnerability remaining after taking into consideration the efficacy of the controls put in place to manage and mitigate the inherent risks. (Exhibit 9, p. 6 n.5.) The consultant says that high residual risk is evidenced by "missing policies, control activities and/or systems." (Exhibit 9, p.6.)

"The higher the assessed risk of material misstatement, the greater the need for the auditor to utilize a combination of audit procedures." *Id.* The auditor may test management's fair value determinations as of the balance sheet date using one or more of the following procedures:

- Confirm the investments, but note that Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does not Exist" of AU section 332 says that, if the auditor determines that it is necessary to test the valuation of the investment, "simply receiving a confirmation from the alternative investment of its investments in securities, either in aggregate or on a security-by-security basis, does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion."
- Review and test management's significant assumptions and the underlying data in its valuation or its analysis of the assumptions and data obtained from the fund manager.
- Reconcile the valuation to the audited financial statements as of the same date.
- Review transactions at or near the balance sheet date. *Id.*

Based on this extensive guidance that the AICPA gave to management regarding the valuation of alternative investments, SCRS' extension allocation to alternative investment, the complex and non-transparent nature of SCRS' $14.5 billion allocation to alternative investments, and his role as a fiduciary to the SCRS and its participants and beneficiaries, the State Treasurer sought assurance that PEBA performed the proper procedures to value SCRS' alternative investments (*See* Exhibit 30, p. 11) and the auditor's scope was not limited. STO asked PEBA for its files that documented their procedures regarding the valuation of investments and were told by PEBA that there were no other files other than the files they had already given us. (*See* Exhibit 33, p. 3.) Therefore, STO attempted to confirm the extent of the files and PEBA's valuation procedures by asking them to confirm the following:

> Therefore, we understand that the only documentation . . . of any valuation procedures performed by [PEBA] as of June 30, 2012, are the BNYM monthly reports (that at least for the alternative investments originated from the third-party investment managers) and the individual audited financial statements that [PEBA] sent to us. (I understand that you do not have audited financial statements for 100% of the investments or even 100% of the alternative investments. I also understand that most, if not all, of the audited financial statements of the funds in which SCRS invested. . . . are as of December 31, 2011, whereas the SCRS' fiscal year is six months later on June 30, 2012.)
>
> From this documentation, we have made certain assumptions about the extent of your procedures regarding the investment valuations as of June 30, 2012. First, [PEBA] merely adjusts the value of each investment in its general ledger to match the value reported by the third-party managers through BNYM. (BNYM does not independently value the alternative investments.) Second, [PEBA] obtains audited financial statements related to some of SCRS' investments as of December 31, 2011, which is six months before the valuations of investments reported in SCRS' June 30, 2012 financial

> statements. You have provided no documentation or evidence of other procedures regarding the investment valuations in SCRS' FY 2012 financial statements. For example, we have seen no documentation or evidence that [PEBA] did anything to understand the nature of the underlying investments in each fund, the investment strategy of each fund, and the methods and assumptions used to value the underlying investments in each fund or to prepare each individual valuation. Additionally, we have seen no evidence of your performance of any roll-forwards from the valuation in each of the December 31, 2011 audited financial statements to the respective value of that investment at June 30, 2012, or how the individual audited financial statements were otherwise used.

(Exhibit 33, p.3.) In its November 7, 2012 response to STO, PEBA did not deny the above (Exhibit 33, p. 2), so STO assumes that the above represents the full extent of PEBA's documentation of and procedures regarding investment valuations at June 30, 2012.

Additionally, PEBA's job to determine and challenge the valuations by third-party managers is made more difficult by two factors: (1) PEBA cannot rely on any work performed by the RSIC to support the valuation of alternative investments, and (2) it cannot reach out to the third-party managers that provided the valuations to ask questions or gather additional information. Regarding the first factor, RSIC did not perform adequate due diligence procedures regarding the valuation of alternative investments provided by the third-party managers. (*See* Exhibit 28.) The consultant clearly stated in August 2012 that RSIC's due diligence procedures and controls regarding valuations do not support the valuations provided by the third-party managers. (Exhibit 27, p. 12.) Regarding the second factor, STO believes that PEBA has little or no contact with any of the external managers. If so, PEBA would have been unable to correct the deficiencies in RSIC's control environment by working directly with the external managers.

With all of the above said and based on the lack of documentation provided by PEBA and other facts, STO questions whether PEBA or RSIC, as appropriate, met the AICPA's requirements for valuing SCRS' alternative investments. The AICPA requirements that appear not to have been met include the following:

- RSIC did not establish an accounting and reporting process for determining the fair value of investments and related disclosure. (*See* Exhibit 27, p. 12.)
- Neither PEBA nor RSIC selected appropriate valuation methods, identified and adequately supported any significant assumptions used, prepared the valuations, or ensured that the presentation and disclosure of the fair value measurements were in accordance with GAAP.
- PEBA did not gain a sufficient understanding of the nature of the underlying investments, the portfolio strategy of the alternative investments, and the method

and significant assumptions used by the fund manager to value the underlying investments.

- PEBA did not obtain audited financial statements for all necessary investments.
- PEBA did not perform a roll-forward for each investment from that fund's audited financial statements at December 31, 2011 to the related values at June 30, 2012.
- PEBA did not have any significant conversation, if any, with third-party investment managers. The only communication of which STO is aware is the audit conformation letter that PEBA signed.

Based on these possible AICPA deficiencies, the audit risk of material misstatement increased greatly and the auditor should have been required to greatly expand its audit procedures. Evidence of this consists of the following:

- The 2012 consultant quantified RSIC's financial statement risk as high residual risk.
- The alternative investments are material and complex, illiquid, and non-transparent.
- PEBA and RSIC lacked sufficient processes and records over valuations. In fact, RSIC's so-called due diligence could not support any of the valuations provided by the third-party managers.
- PEBA, and RSIC in many cases, did not have any detail of each fund's underlying investments.
- PEBA did not interact with the third-party investment managers.
- PEBA does not have personnel on its staff that is experienced and knowledgeable about valuing complex, non-transparent alternative investments.
- PEBA did not mention having the SSAE 16 report(s) related to every alternative investment.
- The auditor couldn't test management's assumptions or analysis or the underlying data used.

After STO communicated with PEBA about investment valuations, STO and RSIC personnel also communicated about investment valuations. (See Exhibit 35.) RSIC dismissed STO's concerns about investment valuations by saying that "as a practical expedient" it could rely on the net asset value (NAV) in the financial statement audit of each fund to estimate the fair value of each alternative investment to be included in SCRS' financial statements. (Exhibit 36.) RSIC's staff cited Accounting Standards Codification (ASC) 820-10-35-59 for this assertion. (Exhibit 36.) However, it does not appear that RSIC or PEBA has met the applicable requirement for PEBA to use the "practical expedient" approach. ASC 820-10-35-59 allows the "practical expedient" approach to estimate a fair value of an alternative investment if it is "calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date." (Exhibit 36.) The AICPA's guidance in Technical Inquiry Service (TIS) Section 2220, Long Term Investments" provides further guidance. Among other things, TIS 2220 "requires [SCRS] to independently evaluate the fair value measurement process utilized

by the investee fund manager to calculate the NAV." (Exhibit 36.) It seems obvious that neither RSIC nor PEBA performed this independent evaluation of each manager's fair value measurement process. Therefore, RSIC's claim that SCRS could use the "practical expedient" approach to valuing complex, non-transparent alternative investments (valued at about $16 billion) seems flawed.

Finally, PEBA and RSIC have made representations regarding the investment valuations, which may not be accurate.

a. As part of the preparation of the FY 2012 financial statements and the corresponding audit, PEBA confirmed the valuation of the investments in its representation letter to the independent auditor. (Exhibit 38, p. 2, item 9.) PEBA's ability to make this representation is in doubt for several reasons. One major reason is that PEBA specifically referenced that it made this representation "in conjunction with the Commission's on-going due diligence procedures," which, of course, the consultant said could not support the investment valuations (Exhibit 27, p. 12). RSIC's new Audit and Compliance Officer confirmed in August 2012 that RSIC's due diligence policies and procedures regarding investment valuation "do not effectively mitigate the risks to the organization." (Exhibit 28.)
b. For the first time and likely because STO was questioning why RSIC was not taking any responsibility for SCRS' audited financial statements, RSIC's CIO and acting CEO confirmed the valuation of investments in a letter to PEBA. (Exhibit 37, p. 2, item 6). Similar to PEBA's representation, RSIC's senior management also relied on "RSIC staff on-going due diligence procedures" to represent that the values provided by the third-party managers are accurate. Again, the consultant said in August 2012 that RSIC's ongoing due diligence procedures (and financial reporting controls) regarding investment valuations could not support the values provided by the third-party managers. (Exhibit 27, p. 12.) The consultant also stated, "[T]he Commission does not maintain controls procedures/controls [*sic*] for overseeing the . . . valuation practices of those investment managers managing the Strategic Partnerships." (Exhibit 27, p. 12 n. 15.)

Although PEBA and RSIC say that they rely on RSIC's controls over investment valuations, it seems that RSIC is not comfortable with the adequacy of its internal controls concerning investment valuations. In August 2012 (after FY 2012 ended), RSIC's Audit and Compliance Officer confirmed that RSIC's due diligence policies and procures regarding investment valuations "do not effectively mitigate the risks to the organization." (Exhibit 28.) Its FY 2013 internal audit plan includes two engagements: (1) a consulting engagement to provide directional support to RSIC investment staff to formalize investment valuation policies and procedures and (b) another engagement to identify key valuation controls and to audit their adequacy and effectiveness. Such acknowledgement about RSIC's poor controls regarding

valuations raises additional questions about the representation that RSIC made to PEBA about the adequacy of investment valuations as of June 30, 2012.

Chairman Williams also stated that SCRS' financial statements are, and always have been, presented in accordance with GAAP and are in compliance with GASB standards. (Exhibit 41.) However, the validity of Mr. Williams' statement is questionable because of the lack of due diligence over investment valuations (as confirmed by the 2012 consultant and RSIC's Audit and Compliance Officer), the incomplete reporting of fees (see item 21 above), and other factors.

Based on the above, STO believes that PEBA may not have fulfilled its "management" responsibility regarding the preparation of SCRS' June 30, 2012 financial statements. Accordingly, the scope of the independent audit was likely limited, and, because of the lack of controls and records, it seems unlikely that the auditor could have gained the necessary persuasive evidence that the valuations were materially correct. Therefore, no one really knows whether the approximate $25 billion valuation of SCRS' investments is materially correct at June 30, 2012. Incorrect valuations and financial statements that do not comply with GAAP have many consequences including their effect on the amount of future contributions by employees, taxpayers, and the State and the amount of the unfunded pension liability.

To put the issue of investment valuation into perspective, third-party managers are primarily paid based on the value of the assets that they manage. Therefore, they have an incentive to overstate the values of the assets that they manage. Bruce Karpati, Co-Chief of the Asset Management Unit in the Division of Enforcement of the Securities and Exchange Commission, said in 2010 that "the manager has incentives to overprioritize compensation" and that the temptation to overvalue assets to boost compensation has "emerged repeatedly." However, although PEBA and RSIC represent that the valuations are materially accurate, PEBA and RSIC appear not to have sufficient controls in place to offset this inherent conflict of interest and to ensure that investment valuations provided by these third-party managers are accurate.

23. RSIC staff admitted to an $18 million overstatement of management fees only after the State Treasurer questioned the high fees. During a routine review of a schedule of FY 2011 Manager Fees (Exhibit 7, p. 2), the State Treasurer noted that the investment fees paid to Mariner Partnership seemed high based on the amount of assets managed by Mariner. STO staff then sent an email dated March 5, 2012 to RSIC staff asking several questions about SCRS's investment in Mariner, including a question about fees paid to Mariner Partners, a strategic partner selected by RSIC. (Exhibit 7.) About a week later, Adam Jordan, acting CEO at the RSIC, sent an email to the members of the RSIC saying that RSIC had overstated Mariner's FY 2011 fees and that there was a corresponding $18.3 million reporting error in RSIC's Annual

Investment Report.[14] (Exhibit 8.) The Treasurer requested an explanation of this error. He received numerous different explanations but never received an adequate explanation. What STO learned, however, was that investment managers (with various conflicts of interest primarily to inflate fees) self-report to RSIC the amount of fees that those managers deduct from SCRS' funds (see Exhibit 8), meaning that RSIC has no control or effective verification process for hundreds of millions of dollars of fees that RSIC commits to and directs the SCRS to pay to investment managers.

In addition to learning that there was not an adequate and timely process to verify millions of dollars of fees paid by SCRS, two other concerns surfaced from the Treasurer's questions about Mariner and its fees. First, RSIC staff did not disclose the $198 million error until after STO inquired about Mariner's fees. STO understands that RSIC staff knew of the $18.3 million error before STO asked about Mariner's fees on March 5. Second, STO learned that the Retirement Division (now PEBA), who was and is responsible for the SCRS' financial statements, did not understand the fee process used by the RSIC, although investment expenses were in excess of $300 million in FY 2011. (Exhibit 8.)

24. Existing law and existing institutions in South Carolina state government provide no effective deterrent to RSIC breaching its fiduciary duty to its co-fiduciaries. Although a fiduciary and his/her staff should be given access to confidential information needed to perform its fiduciary duties (*see* Exhibits 12, p. 18 and 48, p. 6; S.C. Code Ann. § 9-16-360(B)(7)), members of the Commission have allowed RSIC staff to improperly and unreasonably make it difficult for the State Treasurer to have effective access to many documents and to illegally prohibit access to confidential information by the State Treasurer's staff. Although the issue has been discussed at meetings and has been included in media reports, the members of the RSIC have taken no serious action to remedy this critical problem. Without a court action, strong legislation with consequences for non-compliance, or criminal or regulatory action against any wrongdoers, members and employees of the RSIC can continue to violate state and fiduciary laws with little or no recourse, while assets of the trust are unprotected and may be squandered.

25. Cross trades conducted within or between the SPs are non-transparent and conducive to fraud, and RSIC appears to have no controls in place to monitor these risky activities. Cross trades are those transactions within an SP whereby an investment in one fund is transferred (i.e., crossed) to another underlying fund of the SP. (Exhibit 27, p. 4 n.1.) Cross trades raise potential conflicts of interest and valuation issues. (Exhibit 27, p. 5.) For example, the SEC has sued Commonwealth Advisors and Walter Morales for trying to cover up losses through cross-trading among the firm's hedge funds. Regarding SCRS, the 2012 consultant's report states, "[T]he Commission does not maintain controls procedures/controls [*sic*] for overseeing the

[14] Mariner is one of RSIC's 13 strategic partners in which primarily only former CIO/CEO Borden had information in FY 2011. Also Mariner's fees are part of the fees that are netted against appreciation (depreciation) in the fair value of assets and not disclosed separately by RSIC or PEBA as an investment expense.

cross-trading activities and valuation practices of those investment managers managing the Strategic Partnerships." (Exhibit 27, p. 12 n. 15) The consultant found that RSIC's due diligence procedures, which should include procedures related to cross trades, lacking. (*See e.g.*, Exhibit 27, p. 8-9.) The 2012 consultant also reported that RSIC "is looking to expand the due diligence procedures to include the monitoring and oversight of [cross trades]." (Exhibit 27, p. 5.)

26. SCRS has invested over 50% of its assets in alternative investments, where "the potential for fraud is substantial." Bruce Karpati, Chief of the SEC Enforcement Division's Asset Management Division, said in 2010 that alternative investments "often involve complex, illiquid or opaque investments" and that due to the lack of transparency into their investment strategies and operations "the potential for fraud is substantial."

27. Secret conversations appear to have taken place between STO's custodial bank and RSIC. For example, during a meeting among STO, RSIC, PEBA, and BNYM personnel in January 2013, a BNYM employee started to talk about some conversations that BNYM has had with RSIC about Lighthouse, a strategic partner of RSIC. Although BNYM acknowledged that STO, not RSIC, is its client, BNYM and RSIC personnel openly decided that the issue about Lighthouse should not be discussed in the presence of the others in the room. Everyone in the room was a representative of a fiduciary to the SCRS or an employee of the custodial bank.

28. On or about January 17, 2013, Chairman Williams, CIO Harper, Acting CEO Jordan, and some of RSIC's legal staff prevented a properly called special meeting of the RSIC, which was to be held on January 18, 2013. (*See* Exhibit 44.) Earlier the State Treasurer, a member of the RSIC and the custodian of SCRS' assets, informed Chairman Williams of the need for a meeting about a week before the initial funding of a proposed new investment was due. (*See* Exhibit 44.) The Treasurer believed that the RSIC needed to take a second vote to grant final approval of a particular investment before he could fund the investment. The State Treasurer expected the special meeting to take 15 to 20 minutes. Chairman Williams, however, refused to call a special meeting. RSIC legal also issued a letter saying that a special meeting was not needed, while totally ignoring the Commission's discussion of a second vote when it approved a new policy for making investment decisions on July 19, 2012. Although the actual July 19 motion did not mention the second vote (Exhibit 46, p. 45), it is clear from the transcript of that July 19 meeting (Exhibit 46, p. 32, 36-37, 40) and the draft minutes of that meeting (Exhibit 47, p. 4) that a second vote was required. Following the Chairman's refusal to call a special meeting, as allowed by the RSIC's Governance Policies (Exhibit 45), a majority of the members of the RSIC agreed to hold a special meeting (*see* Exhibit 44, email dated January 16, 2013 from Bill Leidinger to Hershel Harper and Adam Jordan), so that the particular investment could be addressed and approved in accordance with the RSIC's July 19-adopted procedure for approving investments. Since the initial funding of the new investment was to be made on January 17, 2013, the State Treasurer received the investee's confirmation that payment on January 18, after a special meeting, would have prevented a contract default. (Note that

Chairman Williams had prematurely executed the LPA.) Mr. Harper and Mr. Jordan with the assistance of Mr. Williams refused to perform the tasks necessary to comply with the state's open meeting laws (i.e., FOIA laws), like posting the agenda at RSIC's place of business. Also STO believes that Chairman Williams with the assistance of some of RSIC's legal staff lobbied the other members of the RSIC not to attend the special meeting. Because Chairman Williams, Mr. Harper, and Mr. Jordan's refused to ensure that the applicable public notice of the meeting was not given and because of the confusion caused by the Chairman and RSIC senior staff, the Treasurer called off the special meeting on the evening of January 17. (Exhibit 44, email dated January 17, 2013 from Curtis Loftis to members of the RSIC and others.) The actions of Mr. Williams, Mr. Harper, Mr. Jordan, and RSIC's legal staff stifled the majority of the Commission, went against existing RSIC governance polices and RSIC's investment approval process, and put the SCRS at risk of defaulting on an investment agreement, when a 15 to 20 minute meeting could have been held to properly approve the applicable investment and resolve any misunderstanding of the July 19-adopted procedure.

29. For a long time, the Chairman of the RSIC was the only member of the RSIC who would see an investment agreement before it was executed. Additionally, it is believed that some Chairmen only saw and signed the signature page. This is a problem because, for example, the State Treasurer believes that at least one LPA includes higher fees than the RSIC approved (*see* item 4 above) and the long-standing procedure of only the Chairman seeing a negotiated LPA did not catch this problem. Since Chairman Williams recently made a unilateral decision to execute at least one LPA without following the new investment approval process (see item 28 above), RSIC continues to have insufficient controls to verify that the contents of the executed LPAs are proper and in agreement with the terms approved by the full RSIC.

30. Former CIO/CEO Borden has maintained a close business relationship with at least two of the RSIC's strategic partners. This is suspicious because, as stated in item 20 above, former Mr. Borden essentially managed the 13 SPs by himself when he was in charge of RSIC (and Mr. Williams seemed to be the only active member of the RSIC committee that oversaw the SPs) and because we suspect that the SPs paid certain expenses of various members and staff of the RSIC and that the lack of transparency of the SPs made them investment vehicles that were very susceptible to questionable activity. In fact, at the March 2013 RSIC meeting, RSIC's new investment advisor said that the SPs got "oversized" under Mr. Borden.
    a. First, Mr. Borden has a continuing business relationship with Lighthouse Investment Partners, an SP of SCRS. He is a member of Delegate Advisors, LLC, an SEC-registered investment adviser (Exhibit 54, p. 20), and J. Scott Perkins, Managing Director of Lighthouse Investment Partners filed a Form D in 2012 stating that Delegate Advisors, Mr. Borden, and Mr. Duncan Allison (a former RSIC employee who resigned from RSIC contemporaneously with Mr. Borden) are related persons to Delegate Lighthouse Select Fund, LLC (Exhibit 55, p. 3, 8).

b. Second, Mr. Borden has a continuing business relationship with Apollo Investment Corporation, another SP of SCRS. Evidence of this continuing relationship includes the following:
    i. He is a director of Athene Holding Ltd. (Exhibit 56, p. 23.) In 2012, Apollo or an affiliate of Apollo is believed to have acquired control of Athene Holding Ltd. (Exhibits 56 and 57.)
    ii. UNC Kenan-Flagler Private Equity Fund lists Apollo Investment Corporation and Delegate Advisors, LLC as investments of the Fund. (Exhibit 58.)

31. Chairman Williams appears to have made an omission of a material fact when he stated in a February 18, 2013 press release, "It is important to remember that this fine return [in 2012] was achieved with some of the lowest investment risk in the public pension universe." (Exhibit 59.) Mr. Williams is likely referencing the alleged lower volatility (which RSIC usually measures via standard deviation) that RSIC alleges is experienced by a portfolio with a high level of alternative investments. This theory of volatility, which RSIC uses to justify its expansive foray into alternative investments, however, is incorrect and incomplete.

    RSIC's theory on volatility, and hence Mr. Williams' statement, may be incorrect because many believe that volatility in illiquid alternative investments is underestimated because of stale pricing and infrequent third-party valuations. Therefore, SCRS' volatility may not be lower at all. In fact, SCRS' actual volatility may be underestimated due the nature of the illiquid alternative investments selected by RSIC.

    RSIC's theory on volatility, and hence Mr. Williams' statement, seems to be incomplete because it fails to acknowledge the many risks assumed by the RSIC by investing in a diverse portfolio, 58% of which is invested in alternative investments. The evidence that these additional material risks exist are pervasive and undeniable. For example:
    a. Mr. Williams omitted to state the critically important fact that alternative investments create an array of new and very dangerous risks that don't exist in a portfolio of publically-traded bonds and stocks. As noted above in items 22 and 26, Bruce Karpati of the SEC's Enforcement Division recognizes the increased risk of an investment manager overstating the value of his fund's assets in order to increase his compensation and that illiquid and complex alternative investments are ripe for fraud. Overstating values is, of course, easier in a non-transparent investment that holds securities whose values are not readily determinable.
    b. The consultants' reports from 2008, 2011, and 2012 also are indications that alternative investments create many risks far beyond volatility risk. In these reports, the consultants raise many internal control, staffing, financial statement, and other issues that would not have been concerns if the RSIC was not investing in alternative investments. (Exhibits 1, 9, 27.)
    c. Further supporting the fact that Mr. Williams appears to have failed to mention the true risks in SCRS' portfolio, RSIC's professionals who had responsibility to manage

portfolio risk gave a presentation in April 2012 in which they stated that "volatility is not the complete risk." (Exhibit 49, p. 9.) RSIC's professionals also mentioned numerous other risks, which are increased by RSIC's high allocation to alternative investments, including operating risk, credit risk, legal and compliance risk, and funding risk. (Exhibit 49, p. 3.)

d. At the February 2013 RSIC meeting, RSIC's investment consultant admitted that volatility is one of many risks in SCRS' diverse portfolio.

32. Because of RSIC's cloak of secrecy, the RSIC wrongfully restricts the State Treasurer's ability to fulfill his custodial duty to safeguard the assets in the SCRS trust fund. For example, in February 2012, STO's senior staff learned that RSIC provided STO's investment personnel with only the signature page of an investment agreement when RSIC requested STO to initially fund a new investment. (Exhibit 61.) These initial fundings can be tens or hundreds of millions of dollars, and STO believes that a mere signature page is not sufficient evidence that a valid and proper investment contract exists, that the agreement matches the terms approved by the RSIC, and that the assets will be safe once they leave the State Treasurer's control. Two months later, RSIC was still providing STO only with the signature pages of complex legal documents. (Exhibit 21.) RSIC has never consented to provide the complete agreement to STO staff who process the initial funding request. Finally RSIC relented and agreed to let the State Treasurer inspect the complete agreement; however, that process is burdensome (requiring primarily online review of complex legal documents) and should be performed by the State Treasurer's qualified legal and investment staff, not the State Treasurer himself.

33. Another concern about the safekeeping of SCRS' assets exists because RSIC does not perform sufficient initial or ongoing due diligence procedures to verify that SCRS' assets are properly safeguarded when SCRS' assets are transferred outside of State custody. (*See* Exhibits 9, 27, 28.) This would appear to be a breach of fiduciary duty even if the amount was small, yet the breach remains unresolved even though the amount of assets outside of the State's custody is not small. Approximately 70% of the SCRS' assets are not in the State's custody. (Exhibit 29.)

Conclusion

STO is extremely concerned that it has tried for about two years to get answers to its questions about the SCRS and particularly the RSIC and to implement needed internal controls to safeguard SCRS' assets but has been stifled by certain members of the RSIC and some of its senior staff. STO's persistence has brought about some victories for transparency and the plan's participants and beneficiaries, but the above red flags represent outstanding issues concerning SCRS. In fact, the mere volume of these red flags raises a red flag. Although reasonable requests for information by a co-fiduciary should be granted, the extent to which RSIC (and PEBA concerning investment valuations) has withheld information from STO and otherwise hindered STO's efforts to assist the State Treasurer in performing his fiduciary duties is extraordinary. One does not go to these lengths and fight so hard to protect his cloak of secrecy without a reason.

STO requests that you consider the red flags presented in this letter and the supporting exhibits and take any appropriate action. Please note that RSIC's cloak of secrecy has prevented STO from obtaining certain documentation and contributes to STO's inability to support some of its beliefs. Although many of the red flags are serious and documented, STO's lack of information may also contribute to the fact that some of the red flags may not result in any findings against or wrongdoings by anyone.

If you would like to discuss any matter in this letter or the exhibits, please contact me at 803-734-2655.

Sincerely,

William J. Condon, Jr.
General Counsel