

Appendix A: BFS Report Allegations and Department of State Treasurer Responses

I. Allegation: \$30 billion in secret accounts

There are no secret accounts with respect to the NCRS. All funds in NCRS are accounted for and publicly reported. The Department's 2012-13 annual report and its online supplements—available on the DST website—list the amount of money invested with each investment manager.¹

The NCRS and its investment managers have custody arrangements with various banks and other financial firms subject to oversight by NCRS staff, auditors, consultants, other investors and regulators. A custody arrangement facilitates safekeeping of assets, trade settlement, clearing, corporate actions, and strong key controls for financial reporting, monetary transactions, etc. Roughly 80% of the NCRS assets are in safekeeping with the master global custodian chosen by the NCRS: BNY Mellon. Other NCRS assets are ultimately held in custody with banks and other financial firms chosen by external investment managers.

For each NCRS investment manager, the staff performs significant due diligence and ongoing monitoring. Prior to hiring an investment manager, NCRS staff performs an operational risk assessment and receives regulatory disclosures, compliance manual table of contents, valuation policy, and audited financial statements. Staff also interacts with current and former investors and investment consultants in assessing target investment managers' attractiveness relative to others with comparable strategies and/or to assist in operational due diligence. On an ongoing basis, staff monitors the investment managers' activities and performance, including receiving annual audited financial statements.

NCRS staff members also are members of Advisory Boards (which have enhanced monitoring and governance rights) for the vast majority of the private equity and real estate fund commitments made by the NCRS.² A change in custodian, administrator or auditor by an investment manager would be a significant event that would stimulate inquiries from NCRS, other investors and consultants.

It should be noted that the allegation of secret accounts is one that the BFS Report's author has made broadly, well beyond his involvement in North Carolina. The author has stated that all public pensions, not simply North Carolina, have "disappeared" assets or "secret accounts." In a May 19, 2014 blog post, the BFS Report's author claimed that "nearly a quarter of all state and local public pension fund assets have disappeared."³

¹ Those documents can be found as **Exhibits 6, 7 and 8** and are regularly posted on the right-hand side of the Investment Management Division website, <https://www.nctreasurer.com/inv/Pages/default.aspx>.

² NCRS Advisory Board memberships, as applicable, are listed in **Exhibit 7**.

³ Edward Siedle, "A Heist Forty Times Greater than Madoff" (May 19, 2014), available at <http://www.forbes.com/sites/edwardsiedle/2014/05/19/a-heist-forty-times-greater-than-madoff/> (**Exhibit 5**). Emphasis added. Similarly, the BFS Report's author wrote, "Hundreds of billions of workers retirement savings swept into secret accounts—unbeknownst to workers." Edward Siedle, "State Pension Transparency is Right Message at Right Time," May 28, 2014, available at <http://www.forbes.com/sites/edwardsiedle/2014/05/28/state-pension-transparency-is-right-message-at-right-time/> (**Exhibit 5**).

II. Allegation: Lack of transparency and responsiveness to public records requests

Today, the Department makes more information public about its investment practices than the majority of public pension plans.

For each external investment manager, the Department's annual report and its online supplement provide individualized performance information and aggregate fees.⁴ Unlike the vast majority of public pension plans, the Department includes in its fee disclosures incentive compensation, commonly called "carry." In fact, all fees have been made publicly available by request during the Treasurer's entire term in office--including asset-based fees and performance fees by investment manager. As an example, consistent with the Department's public records policy and North Carolina law, fee information was provided to WRAL-TV on August 29, 2013, for use in a story and interview with the Treasurer.

The BFS Report states that Treasurer Cowell has failed to disclose some fee and performance data made public by her predecessor, Richard Moore.⁵ In fact, the fee and performance tables developed during Treasurer Moore's tenure have been provided regularly to the press and to the public since Treasurer Cowell took office. Those documents were provided to the author of the BFS Report as part of the Department's first production.⁶ Similar information is now provided, in an easier-to-read format, as a supplement to the Department's annual report.⁷ This information began to be provided with the 2012-13 fiscal year.

NCRS was also the first public pension plan to provide on its website comprehensive disclosures about its managers' hiring of placement agents.⁸ The BFS Report cites a few broken links on the website. These links were fixed on March 2, 2014, when the website was placed on a new platform.

The Department provided more than 14,000 pages of documents⁹ in response to the record request issued by the BFS Report sponsor,¹⁰ with more documents in the production process at the time that the BFS Report was released. However, very few of these documents were cited in the report. The BFS Report repeatedly references offering documents cited in the October, 2013 report BFS wrote on the Rhode Island pension fund, and the report cites text from more Rhode Island offering documents than North Carolina contracts or offering documents.¹¹

⁴ Those documents can be found as [Exhibits 6, 7 and 8](#) and are regularly posted on the right-hand side of the Investment Management Division website, <https://www.nctreasurer.com/inv/Pages/default.aspx>.

⁵ *BFS Report*, pages 6 and 31-32.

⁶ NCDST Document Production SSR, pages 1974-2042.

⁷ See [Exhibits 7 and 8](#).

⁸ <https://www.nctreasurer.com/inside-the-department/OpenGovernment/Pages/Placement-Agent-Disclosures.aspx>

⁹ These thousands of pages of documents included fee information and holdings information for all of the Department's investments (pages SSR-1974 to SSR-2042), many contractual documents (SSR-2043 to SSR-3370 and SSR-3874 to SSR-14385),⁹ and many pages of placement agent disclosures Pages (SSR-0001 to SSR-1643 and SSR-3771 to SSR-3873.) The placement agent documents are also available on the Department's website at <https://www.nctreasurer.com/inside-the-department/OpenGovernment/Pages/Placement-Agent-Disclosures.aspx>.

¹⁰ See [Exhibit 9](#), the transmission letters for the Department's productions of documents. 14,385 pages were produced as of April 4, 2014, within three months of the date of the record request. For comparison, the University of North Carolina at Chapel Hill, which employs nine full-time equivalent employees to deal with record requests, produced 40,000 pages of records in response to requests during all of last year. See Jane Stancill, "Recent scandals at UNC-Chapel Hill boost requests for public records," *Raleigh News & Observer* (March 28, 2014).

¹¹ BFS's Rhode Island report, entitled "Rhode Island Public Pension Reform: Wall Street's License to Steal," is available at <http://www.ricouncil94.org/Portals/0/Uploads/Documents/Rhode%20Island%20X.pdf>. The *BFS Report* cites or quotes text from

The BFS Report criticizes North Carolina for redacting or withholding some documents under the State's Trade Secrets Protection Act. Here, the Department is required to follow existing state law.

For many years, North Carolina law has allowed vendors doing business with the State to designate as confidential their commercially valuable methods, techniques and processes.¹² These proprietary "trade secrets" are available to members of the General Assembly, the State Auditor and other governmental officials upon request, but they are not public record. Otherwise, private companies would avoid doing business with the State, since a public contract would allow competitors to gain a competitive advantage.¹³

The BFS Report repeatedly states that the Treasurer "refused" to provide documents or "denied" a records request. In some of these cases, the Department never received a request seeking that information.¹⁴ In other cases, the Department was providing documents, on a rolling basis, at the time the BFS Report was released.¹⁵

III. Allegation: No audits

NCRS investments have been routinely audited. As a major component of the North Carolina Comprehensive Annual Financial Report ("CAFR"), NCRS investments have been subject to systematic annual external audits from the Office of State Auditor ("OSA"). The CAFR is compiled by the Office of State Controller on an annual basis and the audit opinion is addressed to the Governor and General Assembly. OSA determines scope of work performed based on materiality at the State CAFR level, which means that the Treasurer's investment program and pension investments have been audited in their entirety on an annual basis.¹⁶ There were no reportable financial audit findings in 2012 or 2013 for the standalone audit report on CAFR data, but there have been periodic findings and recommendations.¹⁷

three North Carolina contracts or offering documents – Chapter IV, Aurora Ventures V, and Fortress III. See pages 74-75, 79-82, and 102. The North Carolina *BFS Report* quotes text from five Rhode Island contracts or offering documents that are not present in North Carolina – Indus Asia Pacific Fund, Winton Futures Fund, Brevan Howard, Davidson Kempner, and Ascend Partners II. See footnote 48 of this **Appendix A** for details.

¹² N.C.G.S. § 132-1.2(1); N.C.G.S. 66-152(3). (**Exhibits 10 & 11**)

¹³ The *BFS Report* recognizes that investment managers frequently use public records requests to seek competitive information. See page 33, text supported by footnote 24.

¹⁴ The *BFS Report* repeatedly asserts, when discussing particular topics, that BFS requested "documents related to such potential violations of the securities laws" or "information regarding potential violations of tax law," then states, "Our request was denied." See *BFS Report* pages 18-20, 83, 84, 86. However, the only records request sent by BFS (**Exhibit 12**) did not mention these topics, and there was no communication from the Department of State Treasurer denying requests.

¹⁵ Tens of thousands of pages were within the request's scope. See **Exhibit 10**. The request sought, among other things, all offering memoranda, all investment advisory contracts, and any documents discussing placement agent fees for the time period January 1, 2003 to January 10, 2014, along with all correspondence with a variety of government agencies for the time period January 1, 2008 to January 10, 2014. Before production, all of these documents had to be gathered, then reviewed page by page to redact information that is prohibited from release under North Carolina law. N.C.G.S. §§ 132-1.2(1), 132-1.2(2), and 132-1.10(b)(5). The Department notified the requestor that it would produce documents on a rolling basis when ready. See the first paragraph of the January 28, 2014, March 5, 2014, and April 4, 2014 letters in **Exhibit 9**.

¹⁶ Audit inquiries have addressed areas such as accounting and valuation, operational policies and procedures, internal trading, internal controls of major service providers, internal controls over financial reporting, monthly cash operations, statutory compliance, partnerships' audited financial statements, any major changes in account values, and securities lending.

¹⁷ All OSA reports can be found at: <http://www.ncauditor.net/pub42/Default.aspx>.

OSA also conducts performance audits of the NCRS investments program at its discretion and it engaged in a 2012 Investment Division Performance Audit. The scope included a review of governance structure for investment portfolio activity with a particular focus on the public equity portfolio to review for manager compliance.

Earlier this year, the Investment Fiduciary Governance Commission had extensive discussions with staff and Hewitt EnnisKnupp regarding the potential incremental costs and benefits associated with publishing separate audited financial statements for NCRS investments. The Investment Fiduciary Governance Commission unanimously recommended that annual financial statements for the NCRS investment program be reported to the General Assembly, subject to audit by a commercial independent third-party audit firm. The Treasurer concurred with the recommendations and subsequently recommended that OSA engage the commercial audit firm to ensure independence. The audit would complement and expand the State's existing audit processes.

IV. Allegation: Insufficient reporting to the Joint Legislative Commission on Government Operations

The BFS Report's interpretation of the law is inaccurate. The BFS Report alleges that the Department did not comply with certain legal reporting requirements for placement agent fees and fund-of-fund fees. The BFS Report refers to legislation that was enacted August 23, 2013, related to the Department's quarterly reporting to the Joint Legislative Commission on Government Operations ("Government Operations Report").¹⁸ The revised statute added text that the Government Operations Report "include a specific listing of all direct and indirect placement fees, asset fees, performance fees, and any other money management fees incurred by the State."¹⁹

The Department provided responsive information before the 2013 law was passed, and therefore did not change the format of the Government Operations Report.²⁰ The Department has communicated to the General Assembly its willingness to alter the content and format of the reports and, to date, the Department has received no requests from General Assembly members or their staff to alter the Government Operations Report.

With respect to placement agent fees, by Department policy external investment managers--not the State of North Carolina or North Carolina Funds--bear all placement agent fees and expenses. Thus, there are no placement agent fees to include in the Government Operations Report. We are not aware of any instance in which the State, the Treasurer, or the North Carolina Funds paid placement fees in violation of the policy.²¹ We do, however, provide

¹⁸ N.C.G.S. 147-69.2(b)(10a), added by Session Law 2013-398. (**Exhibit 13**)

¹⁹ *Id.*

²⁰ See <https://www.nctreasurer.com/Inside-The-Department/OpenGovernment/Pages/Annual-Reports.aspx>.

²¹ DST placement agent policy, page 8, footnote 5: Note that an investment vehicle in which the Treasurer is an investor may make a payment to a placement agent as an offset to the North Carolina Funds' future fees or compensation to the Investment Manager. Under the Department's Placement Agent Policy and the State's contracts with the investment managers, this offset of placement fees is allowed if and only if (i) the terms of the management fee offset are fully disclosed, (ii) the placement agent and its compensation are fully disclosed in approved Disclosure Letters under the Placement Agent Policy, and (iii) the North Carolina

detailed reports of all placement agent disclosures, including compensation, on the Department website.²² Furthermore, North Carolina is one of the only state pension funds in the nation to post placement agent disclosure forms online.

With respect to fund-of-funds fees, it is not industry convention when reporting aggregate investment management fees to include fees and expenses of investments held within fund-of-fund vehicles. In the Government Operations Reports, the Department matched this industry convention. To be more technical, the Department has placed fund-of-fund fees in the Government Operations Report only if they are allocated to North Carolina's capital account—in which case we viewed them as being "incurred by the State." Fees and expenses of investment managers that are held within fund-of-fund vehicles are typically negotiated and agreed to at the discretion of the fund-of-fund manager, paid out of the returns of each underlying investment manager, and not the liability of the State or North Carolina Funds. The Government Operations Report provides investment performance that is net of all fees and expenses, including those of underlying investment managers held within fund-of-fund vehicles.

The fees and expenses of these underlying investment managers are monitored. In 2013, Hewitt EnnisKnupp independently reviewed investment manager and fund-of-fund fees and expenses (i.e., investments made between January 2009 to June 2012), including fees and expenses of investment managers that were held within fund-of-fund vehicles. Their review was presented to the Investment Advisory Committee in May 2013.²³ The Department has added a question to our regular survey of investment managers to systematically obtain detailed information on underlying investment manager fees (i.e., asset-based and performance fees) should there be interest in the General Assembly to further expand reporting. As stated previously, all fees and expenses are available at any time for review by the General Assembly and the State Auditor.

V. Allegation: Political interference with investment decision-making

By policy and practice, political issues have no role in investment decision-making. As discussed at the December 2013 meeting of the Investment Advisory Committee, prior to Treasurer Cowell's term in office, several events concerning placement agents raised concern. The Department became aware of these matters because Treasurer Cowell's staff, after she adopted the Department's first Placement Agent Policy in 2009, requested retrospective disclosures from the Department's investment managers. Based on those disclosures, the Department notified the North Carolina Department of Justice, which performed a multi-year investigation. When the Department of Justice's work was complete, the Department of State Treasurer sought remedies, resulting in approximately \$15 million in refunds and fee discounts.

Several pages of the BFS Report allege political interference with investment decision-making.²⁴

Funds do not ultimately bear any placement agent fees and expenses. Available at <https://www.nctreasurer.com/inside-the-department/Policies/PlacementAgentPolicy-Nov-19-2013-WithForms.pdf>.

²² <https://www.nctreasurer.com/Inside-The-Department/OpenGovernment/Pages/placement-agent-disclosures.aspx>

²³ See **Exhibit 14**.

²⁴ *BFS Report*, pages 3, 24-25, 28-29, 57, 64-65, 143-146.

These instances generally either reference the Treasurer Moore investigation or suggest that the Treasurer should, in the report's words, "End the North Carolina Nexus Investment Program."²⁵ The "North Carolina Nexus Investment Program" appears to be the report's terminology for "private equity funds and companies that are based in North Carolina."²⁶ The BFS Report argues that any investment by the Department using a North Carolina firm is inherently suspect.²⁷ The executive summary and section XV of the BFS report recommend "an investigation by law enforcement and the SEC" into "North Carolina nexus investments,"²⁸ claiming without providing any names that "many of the local private equity funds and companies in which TSERS has invested clearly lacked the requisite relevant experience and track records."²⁹

We do not agree that investments in North Carolina are inappropriate. As one of the nation's leading centers of finance, research and innovation, and higher education, North Carolina has and will continue to attract national and international investment capital. The bedrock of the North Carolina Innovation Fund is a balanced mix of co-investments made alongside national investment firms and direct commitments to smaller individual private equity funds that have focused on North Carolina; many of these latter funds are smaller than NCRS would typically make direct commitments to. Under state law, the Treasurer may take into account collateral benefits such as whether an investment is linked to North Carolina only upon a determination "that the investment providing these collateral benefits would be prudent even without [those] collateral benefits."³⁰

Under an SEC rule issued in 2010, political contributions are sharply limited from investment managers to the Treasurer, candidates for Treasurer and certain other state officials.³¹ Executives, salespersons, and their supervisors at investment firms and investment advisers³² may contribute no more than \$350 to candidates for whom they may vote, or \$150 for out-of-state candidates.³³

Following the sections of the report criticizing North Carolina investments, the BFS Report specifically criticizes Credit Suisse.³⁴ The BFS Report relies on dated information to make these inferences. Customized Fund Investment Group, which manages the North Carolina Innovation Fund, was acquired by Grosvenor Capital Management and as of January 2, 2014, is no longer part of Credit Suisse.³⁵

²⁵ *BFS Report*, unnumbered title page entitled "Highlights & Recommendations." Similar statements are made on page 29 of the *BFS Report*.

²⁶ *BFS Report*, page 143.

²⁷ In the report's words, "Pension policies targeting local businesses give rise to heightened concerns regarding potential improper relationships between locals and pension decision-makers that may result in imprudent investments." *BFS Report* page 143. On page 29, the *BFS Report* asserts that a commitment to "enterprises with a nexus to North Carolina presents a heightened risk of improper dealings and yet another discrete opportunity to use pension assets for political advantage."

²⁸ *BFS Report*, pages 25 (executive summary) and 143 (section XV).

²⁹ *BFS Report*, pages 25 (executive summary) and 143 (section XV).

³⁰ N.C.G.S. § 147-69.7(b)(5). (*Exhibit 15*)

³¹ Securities and Exchange Commission rule on Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41,017 (July 14, 2010), amending 17 C.F.R. §§ 275.204-2, 275.206(4)-3, and 275.206(4)-5. (*Exhibit 16*)

³² 75 Fed. Reg. 41,017 at page 41,070, part of 17 C.F.R. § 275.206(4)-5(f)(2), defining "covered associate." (*Exhibit 16*)

³³ 75 Fed. Reg. 41,017 at page 41,024, describing operation of SEC rule. (*Exhibit 16*)

³⁴ *BFS Report*, pages 24-25 and 144-146.

³⁵ See Press Release, "Grosvenor Capital Management Completes Acquisition of Customized Fund Investment Group from Credit Suisse Group AG" (January 2, 2014), available at <http://online.wsj.com/article/PR-CO-20140102-907459.html> (*Exhibit 5*).

VI. Allegation: Performance of alternative investment classes is poor

Alternative investments have made important contributions to overall NCRS performance. Treasurer Cowell has made it a strategic priority to cost-effectively and methodically improve the diversification of the NCRS investments. Table 1 illustrates that over a number of different measurement periods “alternative investments” have made important contributions to total NCRS performance relative to public equity and investment grade fixed income portfolios. Table 2 illustrates that hedge fund vehicles in the aggregate, which are used in several parts of the NCRS, have also performed well versus benchmarks and broad asset classes for several measurement periods.

Table 1: Net of Fees NCRS Total Fund and Asset Class Annualized Returns Data through March 31, 2014

	1 Year	3 Years	5 Years	10 Years	15 Years
Public Equity	19.46%	10.12%	18.79%	6.76%	5.27%
Fixed Income	-0.46%	5.47%	7.08%	5.77%	6.58%
Real Estate	12.34%	10.35%	2.89%	4.62%	5.31%
Private Equity	13.81%	9.41%	9.06%	8.21%	5.35%
Credit Strategies	15.31%	9.97%	-	-	-
Inflation Protection	0.65%	-3.68%	-	-	-
Total NCRS	10.88%	8.26%	12.46%	6.46%	5.98%

Table 2: Net of Fees NCRS Aggregate Returns for Hedge Fund Vehicle Across All Portfolios versus Performance Benchmark – Data through March 31, 2014

	1 Year	3 Years	5 Years	10 Years	15 Years
NCRS Hedge Fund	13.15%	6.49%	8.30%	4.04%	--
Performance Benchmark	5.34%	1.06%	3.69%	2.14%	--

While they have been generally additive to overall NCRS performance, it is also the case that NCRS’ Private Equity and Real Estate performance has lagged peers and benchmarks over a number of periods.³⁶

NCRS Private Equity returns have been negatively impacted by large allocations to partnerships made prior to Treasurer Cowell’s term of office. In addition, NCRS was forced to sell some of the best funds during the Global Financial Crisis to stay below the statutory allocation cap. Furthermore, returns have been affected by a higher-than-optimal reliance on fund of funds, which stems from staff limitations. The latter two factors have detracted almost 2.0% per year since inception from the internal rate of return for the NCRS Private Equity portfolio. Private Equity returns routinely lag public market returns and we expect continued broad recovery in the private equity valuations. Further, the work plan for the next several years emphasizes vintage

³⁶ See Hewitt EnnisKnupp, *Investment Fiduciary Governance Commission Briefing Book, January 23, 2014 (Exhibit 3)* discussing their assessment of asset class structure and performance.

year diversification, valuation discipline, fewer relationships, and avoidance/restructuring of fund-of-funds.

NCRS Real Estate returns have been negatively impacted by large 2005-2007 allocations to “non-core partnerships” that underperformed expectations. Some of these partnerships have posted strong rebounds over the past three years and are expected to return all of the invested NCRS capital or a small premium. Others that were heavier users of leverage and/or were more exposed to the fallout from the Global Financial Crisis are unlikely to fully recover. Looking forward, the strategic investment policy is being reformulated to de-emphasize non-core real estate in favor of lower risk core real estate. Also, the work plan for the next several years emphasizes vintage year diversification, valuation discipline, fewer relationships, and separate account arrangements that typically provide greater control and better fee arrangements than closed-end funds.

VII. Allegation: Fees are too high, especially with alternative investment classes

The NCRS investment program is low cost compared to peers according to several surveys and a recent independent review. According to CEM Benchmarking, NCRS’s costs were about \$80 million lower in 2012 compared to the median peer (Table 3). A survey by R.V. Kuhns shows that NCRS annual fees and administrative expenses as a ratio of assets under management are about 0.11% lower for the NCRS than public pension plans with assets in excess of \$20 billion; similar to the CEM Benchmarking analysis. Finally, Hewitt EnnisKnupp reviewed fees for recent NCRS investments (*i.e.*, January 2009 to June 2012) and reported:

“Fees:

We conducted an extensive analysis of the fee terms for each of the investment transactions in the review universe. The IMD staff is to be applauded for the results they have achieved in negotiating investment fees. They have done an exceptional job.

Key Findings:

1. The fees for virtually all of the global equity managers reviewed were lower than the median for the universe.
2. The management fees for most of the credit strategies and inflation protection investments are also below industry comparables; other fee components for these investments are generally below average or reasonable.
3. For private equity and real estate, overall the fees are reasonable when compared to a universe of comparable investments.”³⁷

³⁷ See [Exhibit 14](#).

*Table 3: Calendar Year 2012 NCRS Costs of Investment Operations Compared to Peers
(Expressed in basis points where 50 basis points equals 0.50%)*

	Total Costs	Investment Management Costs	Oversight, Custodial, and Other Costs
Median Peer	64.2	63.3	1.1
NCRS	53.9	53.4	0.4
<i>NCRS Percentile</i>	<i>40%</i>	<i>40%</i>	<i>7%</i>

Source: CEM [Cost Effectiveness Measurement] Benchmarking Inc., The peer group consists of 16 U.S. public pension funds managing from \$38 billion to \$249 billion. The median peer managed \$71 billion versus NCRS' \$78 billion average size during 2012. CEM Benchmarking's methodology incorporates default average expenses for underlying investment managers held within fund-of-fund vehicles, but excludes carry/performance fees for private investments because most peers do not provide such data. All such fees and expenses have been deducted from all reported investment returns.

Similar to the vast majority of institutional investors, the NCRS investment strategy is more complex and higher cost than a simple stock/bond index fund, but it produces higher returns after fees and lower risk. Earlier this year, the sponsoring organization for the BFS Report recommended that the NCRS investment program should consist of a 65% stock index and 35% bond index portfolio.³⁸ (See Table 4, below, and Chart 1, on the next page, for a simulated performance comparison of the recommended index fund mix and actual net of fees NCRS performance.)

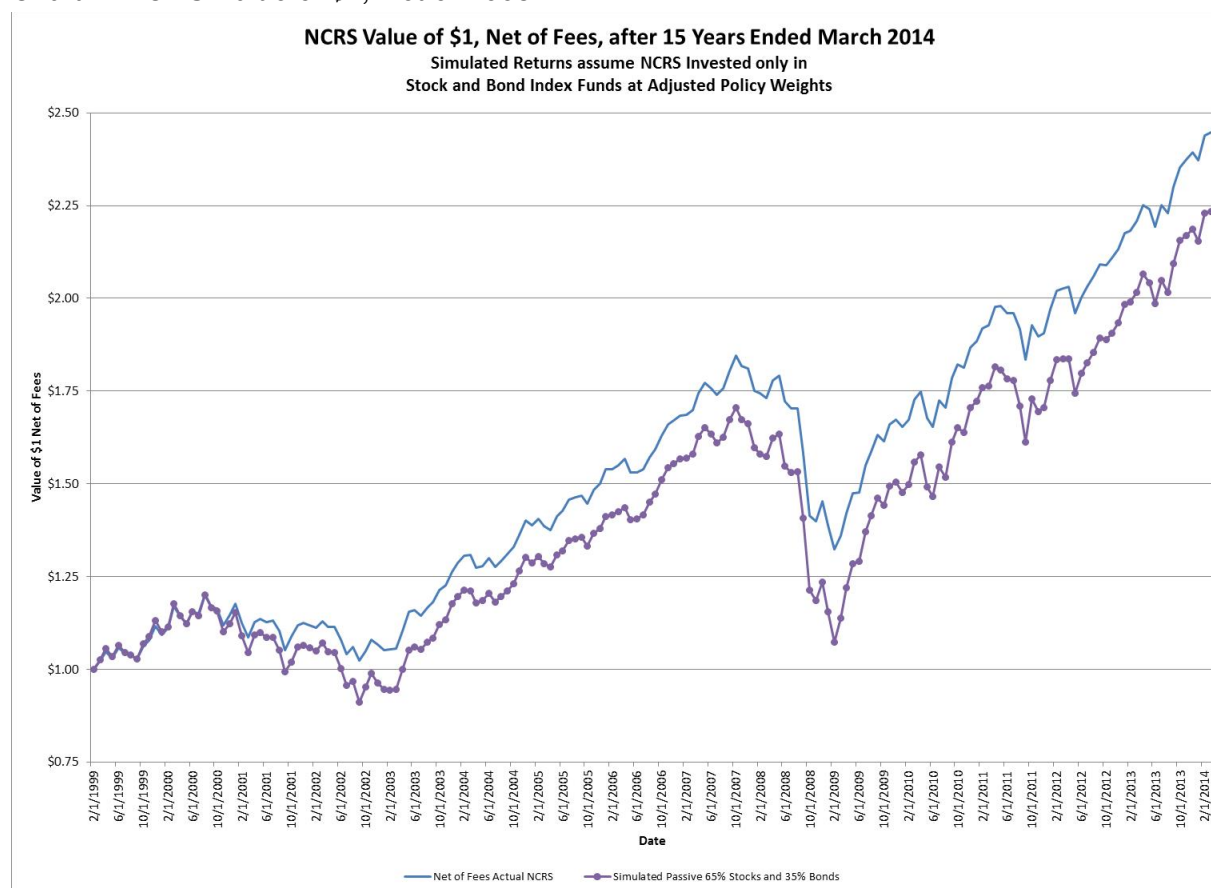
Better performance translates into lower State contributions into the NCRS. Buck Consultants estimates the NCRS strategy will save the State \$1.7 billion in future contributions compared to a 65% stock index and 35% bond index portfolio (*i.e.*, present value of contributions over 30 years, discounted by inflation).

*Table 4: Net of Fees Actual NCRS Total Fund Performance versus Simple 65%/35%
Stock/Bond Index
15 Years of Data through March 31, 2014*

	Net of Fees Actual NCRS Performance	65% Stock Index Fund and 35% Bond Index Fund	Difference
Annualized Returns	5.98%	5.32%	0.66%
Annualized Risk	8.34%	10.56%	-2.21%

³⁸ "Instead, [SEANC spokeswoman Toni] Davis said the pension fund should divest from risky alternatives completely with a 65% allocation to stocks and 35% to bonds." AI-CIO, January 7, 2014 ([Exhibit 5](#)).

Chart 1: NCRS Value of \$1, Net of Fees



VIII. Allegation: SEC investigation is warranted

There is no basis for an SEC investigation. The BFS Report repeatedly calls for an investigation of the NCRS by the U.S. Securities and Exchange Commission (“SEC”), State Auditor, North Carolina Secretary of State, and U.S. Internal Revenue Service, among other agencies.³⁹ It appears that the BFS Report sponsor may have submitted a complaint letter to the Securities and Exchange Commission’s Office of the Whistleblower. However, some press accounts have characterized this as indicating that the SEC is investigating North Carolina’s pension fund. This is not correct.

The SEC Office of the Whistleblower received more than 3,238 tips and complaints during the 2013 fiscal year.⁴⁰ The SEC does not investigate each tip received; instead, “[d]uring the evaluation process, OMI [Office of Market Intelligence] staff examines each tip to identify those that are sufficiently specific, credible, and timely to warrant the additional allocation of Commission resources.”⁴¹ The Department of State Treasurer has not received any indication

³⁹ The *BFS Report* also opines that the SEC should investigate Hewitt Ennis Knupp (*BFS Report* page 62) and private equity firms generally nationwide (*BFS Report* pages 83-84).

⁴⁰ U.S. Securities & Exchange Commission, 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program, page 1, available at <http://www.sec.gov/about/offices/owb/annual-report-2013.pdf>. (**Exhibit 17**)

⁴¹ *Id.* at page 11.

that the SEC, the State Auditor, the Secretary of State or the U.S. Internal Revenue Service has initiated an investigation in response to any complaint made by the BFS Report's sponsor or author.

In appealing for SEC "intervention" in the foreword, the BFS Report declares generally that "the same situation exists at countless other pensions around the nation."⁴² The BFS Report's author and research assistant made similar calls for SEC intervention in Rhode Island⁴³ and Kentucky.⁴⁴ No SEC investigation has taken place in Rhode Island, and concerning Kentucky, the SEC has issued a "no action" letter.⁴⁵

The BFS Report alleges that features common to all private-market investments violate federal laws and regulations. For example, the BFS Report criticizes as potentially illegal the standard contractual language noting that these investments involve an enhanced level of risk⁴⁶ and offering memorandum language noting that the investment manager will have discretion to take action within the guidelines stated by the contract.⁴⁷

The BFS Report also cites as "potential violations" of law certain features of investment programs that they did not observe in North Carolina, but have seen in other states. This portion of the report, focused on so-called "mystery investors," consists primarily of text repeated from the authors' report on Rhode Island, including several lengthy quotations from investment documents found in Rhode Island but not in North Carolina.⁴⁸

Finally, the BFS Report's author calls for an SEC investigation of private equity managers nationwide, including the managers engaged by NCRS, based on a media story raising concerns about fees charged to clients by unnamed private equity firms.⁴⁹ This is not specific to NCRS, but there is a real need to continue to closely monitor private market investments. The Department expects, for each private market fund in which it invests, that the investment manager will comply with its contract and the fund's auditor will perform a thorough review of the fund's financial records.

⁴² *BFS Report*, page 3.

⁴³ BFS Rhode Island report, pages 9, 16, 17, 20-24, 50, 72-73, 86-87, available at <http://www.riCouncil94.org/Portals/0/Uploads/Documents/Rhode%20Island%20X.pdf>. It is not clear from the public record whether any organization contacted the SEC whistleblower hotline concerning the Rhode Island fund.

⁴⁴ Chris Tobe, who is credited as providing research assistance on page 147 of the *BFS Report*, is stated by BFS to have filed a whistleblower complaint with the SEC in September 2010. Mr. Tobe hired BFS as "independent counsel" to produce a report styled as a submission to the SEC. See "Report of Independent Counsel to SEC: Placement Agent Abuses at Kentucky Retirement System," March 12, 2012, pages 1-2, available at <http://blogs-images.forbes.com/edwardsiedle/files/2012/03/KRS-PDF.pdf>. Mr. Tobe stated that he later filed a supplemental submission to the SEC Office of the Whistleblower. See State Budget Solutions, "Kentucky State Pension Catastrophe a Warning Signal to Others" (Dec. 14, 2012), second and eighth paragraphs (*Exhibit 5*).

⁴⁵ John Cheves, "Federal Review of Kentucky Retirement Systems Ends with No Action, Agency Says," *Lexington Herald-Leader* (July 16, 2013), (*Exhibit 5*).

⁴⁶ *BFS Report*, page 73.

⁴⁷ *BFS Report*, page 79.

⁴⁸ See *Appendix B*, pages 4 to 6. The investment documents found in Rhode Island, but not North Carolina are Indus Asia Pacific Fund (page 57 of Rhode Island report, quoted without attribution on page 76 of NC report); Winton Futures Fund (page 57 of RI report, quoted without attribution on page 76 of NC report); Brevan Howard (page 58 of RI report, quoted as a document "reviewed elsewhere" on page 77 of NC report); Davidson Kempner (page 58 of RI report, quoted without attribution on page 77 of NC report); and Ascend Partners II (pages 58-59 of RI report, quoted without attribution on page 77 of NC report).

⁴⁹ *BFS Report*, pages 83-84.