Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems

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June 28, 2011

Jennifer Elliott, Chairman
Board of Trustees
Kentucky Retirement Systems
Perimeter Park West
1260 Louisville Road
Frankfort, Kentucky 40601

RE: Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems

Dear Ms. Elliott:

We have completed our examination of certain controls and management practices of the Kentucky Retirement Systems (KRS). The enclosed report presents, in total, 21 findings and offers 92 recommendations to strengthen KRS' controls and management oversight procedures.

Examination procedures included interviews of current and former KRS Board members, current and former KRS staff members, KRS consultants, and others. In conjunction with a review of applicable KRS policies and procedures, a sample of travel voucher reimbursements and procurement card purchases was examined to determine whether expenditures were appropriate and made in compliance with KRS policies. Our examination also included a review of the KRS Internal Auditor's draft report relating to placement agents. Our examination included records and information for the period July 1, 2007 through June 30, 2010, unless otherwise specified. The objectives developed by the Auditor of Public Accounts for this examination include:

- Evaluate various KRS policies, internal controls, and other aspects of the KRS operation;
- Ensure the transparent, efficient use of financial resources; and
- Make recommendations to strengthen and improve internal controls, as well as the oversight and operations of KRS.

Specific items scrutinized in the examination include: policies governing the internal audit process, staff reporting to the KRS Board, business conduct, conflict of interest, ethics policies, the use of placement agents at KRS, certain procurement policies, and the adequacy of current audits and financial reports.

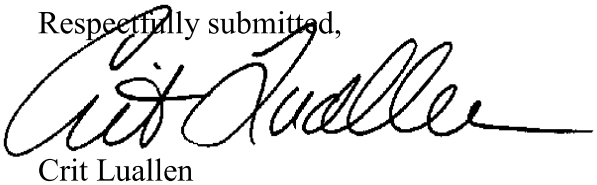
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AN EQUAL OPPORTUNITY EMPLOYER M / F / D

The purpose of this examination was not to provide an opinion on financial statements or investment decisions, but to ensure that processes are in place to provide strong oversight of financial activity through a review of KRS organization's policies, Board governance, certain internal controls, and other financial transactions.

Due to the nature of certain matters discussed within this report and the ongoing U.S. Securities and Exchange Commission (SEC) "informal inquiry" into KRS, we will refer this report to the SEC's Municipal Securities and Public Pension Unit.

The Auditor of Public Accounts requests a report from KRS on the implementation of audit recommendations within (60) days of the completion of the final report. If you wish to discuss this report further, please contact Brian Lykins, Executive Director of the Office of Technology and Special Audits, or me.

Respectfully submitted,



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Auditor of Public Accounts

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AUDITOR OF PUBLIC ACCOUNTS

Performance and Examination Audits Branch
Executive Summary
June 28, 2011

Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems

Examination Objectives

In August 2010, KRS internal auditors presented a draft audit report on the use of placement agents in KRS investments. This report was not approved by the KRS Board of Trustees and was sent back to the KRS Audit Committee for further review. During the September 2010 meeting of the Audit Committee, committee members voted to ask the APA to examine the use of placement agents at KRS rather than having KRS internal audit staff perform additional audit procedures. In an October 5, 2010 letter to the KRS Board Chair, the APA committed to perform a review of certain aspects of KRS. The purpose of this review was to address the following objectives:

- Evaluate various KRS policies, internal controls, and other aspects of the KRS operation;
- Ensure the transparent, efficient use of financial resources; and,
- Make recommendations to strengthen and improve internal controls, as well as the oversight and operations of KRS.

The scope of this review includes records, activities, and information for the period July 2007 through June 2010, unless otherwise specified; however, the time period of certain documents reviewed and various issues discussed with those interviewed may have varied.

Background

KRS administers three retirement systems which are qualified defined benefit plans under Section 401(a) of the Internal Revenue Code. As of June 30, 2010, these three systems served a combined total of 318,981 active, inactive, and retired members. The composition of the members participating in each system is as follows:

- Kentucky Employees Retirement System (KERS) – 123,138;
- County Employees Retirement System (CERS) – 193,690; and,
- State Police Retirement System (SPRS) – 2,153.

Each system offers a defined benefit pension, as well as health insurance benefits, to its participating members. Upon retirement, a defined benefit plan pays lifetime monthly benefits based on a formula established by statute that takes into account an employee's years of service and the highest average compensation of a three or five year period. Under a defined benefit pension plan, public employees are "promised" certain benefits based on years of service and salary amounts. This promise is considered an inviolable contract of the Commonwealth, which cannot be reduced for any current employee or retiree and as such it is protected by state law and also the Kentucky and U.S. Constitutions.

While the retirement contract is inviolable, specific details and calculations have been altered in recent years by the Kentucky General Assembly. Many of these significant changes were included in the Pension Reform Bill from a 2008 Special Session of the legislature, which mostly affected new employees, created: a new benefit tier for employees who began participating in the KRS after September 1, 2008; a one percent health insurance contribution by employees who began participation in the KRS after September 1, 2008; an increase in the number of years required for full retirement for new employees to 30; and new vesting requirements for health care coverage to 10 years. It also instituted a one and one-half percent limit on the annual Cost of Living Adjustment (COLA) for all retirees.

Funding for plan benefits is provided through three sources: the contributions paid by employees, the contributions paid by employers, and the return on investments. Beginning in FY 1993, the General Assembly has not fully funded KERS and SPRS for 12 out of 17 years. The enacted employer contribution rates beginning in FY 2003 for these systems have been consistently and significantly less than the recommended rates, contributing to a decrease in net assets for each plan within the two systems. This situation has resulted in an unfunded liability to meet future retirement costs based on actuarial projection.

In order to help reduce the unfunded liability KRS entered into a contract with the Centers for Medicare and Medicaid Services (CMS) to establish an Employee Group Waiver Plan for pharmacy benefits for Medicare-eligible retirees that led to an immediate reduction of over $1.7 billion to the unfunded insurance liability for the fiscal year ended June 30, 2009. The General Assembly also passed the Pension Reform Bill during a 2008 Special Session that included a schedule to increase employer contributions each year starting in FY 2011, until reaching the full annual required contribution (ARC) in 2025 for KERS non-hazardous, in 2019 for KERS hazardous, and in 2020 for the SPRS plans.

The KRS Board consists of nine trustees including: three appointed by the Governor, two elected by KERS members and retirees, two elected by CERS members and retirees, one elected by SPRS members and retirees, and the Secretary of the Personnel Cabinet. KRS Board trustees serve a term of four years and cannot serve more than three consecutive terms. The standing committees of the KRS Board include the Administrative Appeals Committee, Disability Appeals Committee, Audit Committee, Investment Committee, Legislative and Budget Committee, Human Resources Committee, and the Retiree Health Plan Committee.

The KRS Board trustees select and hire an Executive Director to administer all KRS programs and oversee approximately 250 KRS employees. KRS Board trustees also select a Chief Investment Officer, who reports directly to the Investment Committee; and a Director of Internal Audit, who reports directly to the Audit Committee.

The assets of KRS are considered trust funds. The trust funds include investment earnings, employee contributions, and employer contributions from agencies that are supported by the General Fund, the Road Fund, Federal Funds, and Restricted Funds. All expenses incurred by KRS, including administrative expenses, are paid from these trust funds. Essentially, the General Assembly transfers the restricted funds budgeted for the operations of KRS in the *Budget of the Commonwealth* from the trust funds held by KRS solely for the benefit of members, retirees, and their beneficiaries. Even though the administrative expenses are included in the *Budget of the Commonwealth*, no General Fund dollars are appropriated to KRS. In fiscal year 2010, KRS had total administrative expenses of $34,551,000.

APA Board Recommendation Review at KRS

As part of our examination of KRS, we performed a comparison of certain KRS policies, procedures and practices to the APA's "Recommendations for Public and Nonprofit Boards." Through this comparison to the APA's 32 recommendations, we found KRS policies, procedures, and practices generally provide effective structure for the financial oversight of KRS. However, we make recommendations in Chapter 3, Findings and Recommendations, to further strengthen KRS controls and provide for greater Board oversight.

Findings and Recommendations

Placement Agent Findings

The APA found that the use of placement agents was not transparent at KRS. One placement agent worked closely with the former CIO and was involved in numerous KRS investments without the knowledge of other KRS investment staff, KRS management, or the Board. Transparency is needed to ensure that investment decisions are made in the best interests of KRS and not the interests of placement agents or other parties. It was also determined that the payment of placement agent fees by investment managers did not correlate to an increase in the management fees paid by KRS or reduce the funds available to pay benefits to retirees.

Questions have been raised whether it is necessary for placement agents to be involved in KRS investments. SEC allows placement agents to operate in compliance with established SEC rules. Each public pension system must determine whether the involvement of placement agents is acceptable or should be prohibited. Certain investments may be unavailable to organizations that decide to ban investment managers that use placement agents. Therefore, the effect on KRS investment opportunities must be weighed against the risk of involving placement agents and whether this risk can be sufficiently mitigated through policy and monitoring.

Based on the information available to the APA, auditors found no evidence that a "pay-to-play" situation similar to those in other states has occurred at KRS. However, the APA's report will be referred to the SEC, which has the authority to determine if further investigation is warranted.

Finding 1: Former CIO violated KRS Placement Agent Statement of Disclosure Policy.

Related to a KRS investment approved at the September 29, 2009 Investment Committee meeting, the recommendation memo presented by the former CIO did not disclose that a placement agent was involved. The placement agent attended the Investment Committee meeting; however, the former CIO did not introduce him or inform the committee members of the placement agent's role in the investment. KRS approved a commitment to invest up to $200 million, in $50 million increments, without the knowledge that a placement agent was used and would be paid a fee by the investment manager. This is a direct violation of the Placement Agent Statement of Disclosure Policy that was adopted by the KRS Investment Committee on August 6, 2009, and ratified by the full Board on August 20, 2009.

Recommendations: We recommend that KRS ensure that all information required by the Placement Agent Statement of Disclosure Policy is presented to the Board of Trustees or a designated committee in a clear and transparent manner. We also recommend that KRS Trustees ensure full compliance with Placement Agent Statement of Disclosure Policy and inquire as to whether there is a placement agent involved in an investment decision. We further recommend that the KRS Internal Audit Division ensure that the criteria used in their findings are based on the actual and complete policy requirement when comparing what should be happening to what is happening and report noncompliance with the policy.

Finding 2: Full disclosure of placement agent information was not obtained by KRS staff as required by the Placement Agent Statement of Disclosure Policy.

Significant disclosure of placement agent information is required by the Placement Agent Statement of Disclosure Policy (Disclosure Policy), adopted by the KRS Board in August 2009. This information was not obtained by KRS staff for an investment approved in September 2009. The Disclosure Policy requires that KRS staff are to obtain a written statement from the investment manager disclosing the use of a placement agent. If a placement agent was used by the investment manager, KRS staff are required to obtain ten specific items of information in writing from the investment manager prior to any investment being made. None of this information was obtained from the investment manager prior to the September 2009 investment being approved by the Investment Committee. After the approval of the investment, the final contract only included four of the required items.

Recommendations: We recommend that the KRS Board amend the Placement Agent Statement of Disclosure Policy to include a specific party responsible for obtaining the disclosure information from investment managers. This may be specific to the CIO or include other related KRS investment staff. We also recommend that the KRS Legal Office work in conjunction with the KRS investment staff to develop a questionnaire to be distributed to potential investment managers to collect the required placement agent information. We further recommend that the KRS Board revise the Placement Agent Statement of Disclosure Policy to ensure that all items disclosed by an investment manager are presented to the Investment Committee for review and consideration. Investment Committee members should be aware of all requirements in the investment policies to ensure they are enforced and used to guide the work of investment staff as committee members intended. Finally, we recommend that the KRS Board amend the Placement Agent Statement of Disclosure Policy to require the investment manager include political contributions made by the placement agents to any Kentucky official within the prior two years.

Finding 3: Placement agent appears to have acted as a representative of KRS without disclosure to the Investment Committee.

The former KRS CIO worked in conjunction with one placement agent in a manner that lacked transparency and may not have been in the best interests of KRS. This working relationship appears to be different than that of other placement agents that had been in contact with the former CIO and resulted in the placement agent appearing to act as a representative of KRS rather than for the investment managers. This could conflict with the interests of KRS, as the placement agent may encourage an investment based on the placement agent fee received from the investment manager and not whether it was a good investment for KRS. Further concerning, it appears the former CIO did not fully disclose the extent of the placement agent's involvement to the Investment Committee, investment staff, investment consultants, and executive staff. This placement agent was involved in more investments during the former CIO's tenure than any of the other placement agents combined, indicating the possibility of preferential treatment.

Recommendations: We recommend that KRS Investment Committee members ensure that all adopted investment policies are carried out by staff as intended. This can be accomplished by requiring reports and disclosures concerning the activities of investment staff

and KRS contractors as discussed in Findings 2 and 4. Investment Committee members should ensure they are familiar with the adopted policies so that they are able to ask the mandatory questions related to these policies. We also recommend that the KRS Investment Committee and Board strengthen the Placement Agent Statement of Disclosure Policy by establishing guidelines for how the information provided is evaluated. This includes what action to take if a conflict is revealed between the placement agent and KRS staff members or officials. Finally, we recommend to further enhance transparency the General Assembly consider requiring the registration of placement agents as executive agency lobbyists with the Executive Branch Ethics Commission. This action may require expanding the definition of "Executive agency" in KRS 11A.201(6) to include Kentucky Retirement Systems.

Finding 4: A standardized investment recommendation process did not exist under the former CIO.

Prior to adopting additional investment policies in February 2011, KRS investment policies did not include specific guidelines for the type of information that must be presented to Investment Committee members when KRS investment staff submits recommendations for investments. The lack of standardization allowed the former CIO to determine what information would be provided to committee members as part of their review and approval process. This resulted in the Investment Committee not being informed of placement agents, KRS contracted investment consultants not providing recommendations for certain investments, and investment staff concerns not being considered.

Recommendations: We recommend that KRS investment staff and Investment Committee members ensure consistent compliance with all established investment policies. In addition to the information currently required to be presented to the Investment Committee under the addendum to the Transaction Policy for Limited Partnerships, investment staff should include the following information:

- The specific KRS investment policy and strategy associated with the investment and how that investment meets the requirements;
- Which firms were considered as the primary options;
- What steps were undertaken to locate the firms considered and all individuals or firms involved in identifying investment options and their services;
- Any risks associated with the recommended investment and the mitigating factors that allowed the investment to be recommended; and,
- A recommendation from at least one investment consultant on contract with KRS or explanation of why no consultant recommendation could be given.

We also recommend that KRS establish a formal method for investment staff to convey concerns about a potential investment to Investment Committee members when their concerns are not addressed by the recommendation memo. This method should alleviate the concern of reprisal. Investment staff should also be informed to bring concerns to the KRS Division of Internal Audit if possible fraud is suspected.

Internal Audit Findings

A final report draft of the KRS internal audit concerning placement agent involvement in KRS investments was submitted to the KRS Board for approval in August 2010. The draft report contained six findings and provided seven recommendations to KRS. The draft report also included an appendix that listed the placement agents involved in KRS investments over a five year period and their fees paid by investment managers. While the report draft had been approved previously by the Audit Committee, the full KRS Board did not approve the report due to concerns about the internal audit process and the resulting draft report. These concerns included that the report was purposefully delayed or information was withheld and that the audit may have been influenced by outside sources.

To address the concerns, the APA conducted interviews and reviewed extensive documentation and found no evidence to demonstrate that information from the internal audit was withheld, delayed, or otherwise covered up with the purpose of hiding fraud or other wrongdoing. The APA findings related to KRS internal audit involve the procedures used to monitor the internal audit function and ensure that this process maintains its independence from KRS management. Exhibit 3 provides a timeline of events and correspondence affecting the internal audit of placement agents.

Finding 5: Procedures for conducting a special audit that would document the requirements of the Division of Internal Audit or the Audit Committee did not exist.

The current Division of Internal Audit Procedures Manual (Procedures Manual) dictates that the Audit Committee must annually approve the schedule of audits contained in the Annual Audit Plan in May, but it does not contain any procedures on how special audits should be initiated, approved, or conducted. Specifically, the Procedures Manual does not require that the Division of Internal Audit request preapproval or guidance from the KRS Audit Committee on special audits not included in the Annual Audit Plan. The Director of Internal Audit did not inquire as to what procedures to follow in the absence of a documented process, but relied on professional judgment when the former KRS Executive Director requested a review on the use of placement agents. The lack of procedures limited the involvement of the Audit Committee and caused confusion regarding the audit process among Audit Committee members and the Division of the Internal Audit.

Recommendations: We recommend that the KRS Audit Committee develop and approve procedures that document the requirements related to special audits requested by management or external sources. Because the Audit Committee is only required to meet on a quarterly basis, procedures must be developed to guide the day-to-day activities of the Division of Internal Audit. The adopted procedures should state the Audit Committee's process to request and approve special audits, whether preliminary research should be conducted prior to approval, the amount of the Audit Committee's involvement in the audit scope and methodology, the type and method of communicating information to the Audit Committee prior to the completion of the audit, the distribution of the draft audit report, and when a special meeting should be conducted to discuss a special audit. We recommend that the Fraud Management Policy be integrated into the Internal Audit Procedures Manual. See Finding 9 for further discussion.

Finding 6: The involvement of executive staff in the internal audit process diminished the perception of independence within the internal audit function.

The KRS Internal Auditors included the former Executive Director and former General Counsel in the performance of the Placement Agent Audit, potentially compromising the integrity of the audit and creating a perception of a lack of independence in the internal audit function. Internal auditors requested that the former General Counsel attend three interviews conducted as part of the internal audit process and allowed the former Executive Director to also attend. The former General Counsel also conducted research on a particular placement agent on behalf of the internal auditors. Further, the former Executive Director and former General Counsel were consistently updated on the potential concerns revealed during the fieldwork phase of the Placement Agent Audit, while the Audit Committee was not informed of the specific findings until the final draft report was released. While there is no evidence to demonstrate that either the former General Counsel or the former Executive Director unduly influenced the internal auditors or the audit process, their direct involvement diminished the perception of independence and thus the integrity of the final audit product.

Recommendations: We recommend that the KRS Division of Internal Audit conduct all audit fieldwork in an independent manner separate from the influence of KRS management. Managements' role is to provide the requested documents but it does not include performing audit procedures or evaluating documents, audit findings, or audit conclusions. We also recommend that the Director of Internal Audit retain outside counsel if there is any perceived conflict in the use of the KRS General Counsel for legal assistance, as allowed for under the Audit Committee Charter. Outside counsel also includes the assistance of the Attorney General's Office as allowed for under KRS 61.645(11). We recommend that the Division of Internal Audit operate with the understanding that audit working papers are not subject to the open records law, KRS 61.872, as allowed for in KRS 61.878(1)(i) and (j) and as stated in various Kentucky Attorney General opinions. However, it should be clearly understood that a document already subject to open records that is placed in audit working papers retains its identity as an open record.

Finding 7: KRS does not have a specific budget for the Division of Internal Audit.

The KRS budget does not include a separate line item for the Division of Internal Audit. The lack of a specific budget for internal audit potentially limits the Audit Committee's oversight of the internal audit function and the independence of the internal audit function. The budget for the internal audit function is instead developed by the COO based on discussions with the Director of Internal Audit and then submitted to the Board of Trustees for approval as part of the overall KRS budget. There is no documentation of the amount of funds allocated to the Division of Internal Audit because the KRS budget is compiled by expense category and not by office grouping. In the event that

the Director of Internal Audit assesses a need to expend funds beyond staff and regular supplies, a request must be submitted to the COO. It is then at the discretion of the COO to determine availability of funds under the budget. This reduces the independence of the internal audit function because the executive staff can control Internal Audit's funding.

Recommendations: We recommend that the Audit Committee approve an annual budget of the Division of Internal Audit based on the approved internal audit plan. The Director of Internal Audit should request the amount of funds estimated to conduct the internal audits approved by the Audit Committee. Any additional funding should also be requested by the Director of Internal Audit to the Audit Committee for approval. In addition, budgeted funds should be related to completing or expanding the internal audit plan, such as expenses for external audit assistance, independent counsel, technology upgrades, or other expenditures necessary for the internal audit function to operate as approved by the Audit Committee. Once approved by the Audit Committee, the annual budget for the Division of Internal Audit should be ratified by the full Board of Trustees to be included in the KRS budget by the COO. We also recommend that the budget for the Division of Internal Audit be well documented as a specific item in the KRS budget. The amounts available should be clearly budgeted and used by the KRS Audit Committee as a planning tool to monitor the resources that are available for the internal audit function.

Finding 8: The former Executive Director was involved in performing the evaluation of the Director of Internal Audit and did not include the full Audit Committee as required by the Internal Audit Procedures Manual.

The Director of Internal Audit has not received a performance evaluation by the full Audit Committee as required by the Division of Internal Audit Procedures Manual. Instead, evaluations were conducted by the former Chair of the Audit Committee and the former KRS Executive Director. This current practice is not in keeping with the Procedures Manual and is counter to the intentions of the Audit Committee Charter and infringes upon the independence of the Internal Audit function at KRS.

Recommendations: We recommend that the full Audit Committee of the Board of Trustees participate in the evaluation of the Director of Internal Audit as required by the Internal Audit Procedures Manual. Members of the Audit Committee may seek input from the Executive Director or any other appropriate KRS staff, but only Audit Committee members should be directly involved in the evaluation meeting with the Director of Internal Audit. The opinions of KRS management should be tempered by the fact that the Audit Committee and the Director of Internal Audit are responsible for evaluating KRS operations.

KRS Board Governance and Operational Policy Findings

Finding 9: KRS policy allows management to insert itself into the fraud investigation process.

KRS approved the Fraud Management Policy on May 21, 2009, that addresses allegations of fraud and illegal acts, but the required procedures mainly involve executive management and provide for only minimal input from the Audit Committee. While these procedures have never been used, inserting management into key steps of the fraud investigation process, such as determining who would participate in the investigation, management is aware of the potential fraud and the investigation findings prior to the presentation of the report to the Audit Committee. Management involvement potentially compromises the independence of the fraud investigation process. Similar to other internal audit investigations, independence from management is needed to protect the integrity of the fraud investigation process.

Recommendations: We recommend KRS revise its current Fraud Management Policy to remove the requirement of an investigative team and incorporate the Fraud Management Policy fully under the internal audit function. We recommend the Audit Committee determine whether to conduct a formal investigation based on the recommendations of the Director of Internal Audit and input from Audit Committee members. We further recommend the Audit Committee determine the process for distributing the draft investigative report. See Finding 5 recommendations.

Finding 10: KRS policies should be strengthened to achieve greater accountability.

Through our evaluation of KRS policies relating to a number of administrative issues, opportunities were indentified for KRS to strengthen its policies and achieve greater accountability. KRS policies do not address the timing of when staff or trustees are required to reimburse KRS for any personal expenditure that may have been incurred. KRS also policies do not provide guidelines or maximum amounts for allowable entertainment expenses. KRS ProCard policies do not require supporting documentation of ProCard charges, a deadline for this submission, or a penalty for not

providing support in a timely manner. The 12-month period for conducting an orientation for new Board trustees is too long and it was only conducted by the former Executive Director and the former KRS Board Chair.

Recommendations: We recommend that the KRS Board revise its policies to address the timing of staff or trustee reimbursements to KRS for any personal expenditure that may have been paid by KRS. A stringent deadline should be established, as well as, the actions taken for those that do not comply with this policy. We recommend that the KRS Board revise its policies to establish guidelines and limits on spending for the purpose of entertainment. The policy should clearly define the circumstances when it is appropriate to incur such expenses, the purpose for the expenses, and the maximum purchase amount allowed. We also recommend that the KRS Board revise its ProCard policy to require ProCard holders to submit invoices and any other documentation necessary to support the charges made. The policy should also establish a specified amount of time allowed for this submission and the actions that will be taken for those that violate the policy. We finally recommend that the KRS Board revise its new trustee orientation policy to require that it is performed within the first months of the trustee's service on the Board. The policy should require that the orientation be facilitated by a knowledgeable, independent party, such as a Board attorney or consultant with an emphasis on the legal and fiduciary responsibilities of Board trustees. The Board should consider requiring presentations by the CIO and other director level personnel as part of the orientation as well.

Finding 11: KRS did not consistently comply with its travel policies

During this examination, we requested and reviewed a sample of KRS travel vouchers for the period July 1, 2007 through June 30, 2010. The samples included all travel of KRS Board trustees, Executive Directors, General Counsels, COO, former CIO, and all Investment Directors. The auditor's review of this sample did not find excessive levels of spending on travel; however, we determined that KRS did not consistently enforce its travel policies related to obtaining pre-approvals for travel and consideration of the most economical accommodations.

Recommendations: We recommend that KRS enforce its policy requiring pre-approval for travel and the reviewer consider whether lodging is the most economical for the location. Any travel expenditures incurred without proper pre-authorization should be brought to the attention of the KRS Board for determination as to the appropriateness of the trip and related expenses. We recommend that the KRS Board revise its travel policies to require that Request for Travel forms be submitted along with the travel vouchers to ensure that employees only receive reimbursement for the business related expenses that were pre-approved. We recommend that KRS revise its Request for Travel forms to include a space for the Executive Director or his designee to document the date of approval.

Finding 12: KRS policies did not require all members of the executive staff, including the Chief Investments Officer, to complete a conflict of interest statement.

The KRS Conflict of Interest and Confidentiality Policy Section 4 (1) requires the Executive Director and KRS Board trustees to complete a written conflict of interest statement. While other KRS policies that apply to the KRS Board and Executive Director also apply to executive staff, including the CIO and General Counsel, the conflict of interest and confidentiality policy does not.

Recommendations: We recommend the KRS Board revise its conflict of interest policy to include, at a minimum, a requirement for the CIO, Investment Directors, and General Counsel to file an annual written conflict of interest statement. We further recommend the KRS Board expand upon its conflict of interest statement to allow for an actual listing of relationships or actions that may cause a potential conflict. The form should identify the types of relationships and actions that should be disclosed, such as investments, past work relationships, political contributions, speaking engagements, gifts, or other potential conflicts of interest that may be of possible interest to KRS. This form should allow the individuals to provide a brief description of the relationship or action listed and should be regularly updated by individuals as their circumstances change.

Finding 13: The KRS Conflict of Interest and Confidentiality Policy does not specify a penalty for violating the policy.

In 2009, an active trustee inquired about jobs with KRS investment contractors and informed the media of a planned investment manager contract termination prior to the KRS Board meeting. To address these actions, the former KRS Board Chair removed this trustee from the Investment Committee and filed a formal complaint with the Executive Branch Ethics Commission (Commission); however, these actions are not

documented in the KRS Board minutes. The KRS Conflict of Interest and Confidentiality Policy does not specify a penalty for violations. Without a stated penalty for violating this policy, it is difficult for the KRS Board to openly discuss the issue and to determine the appropriate response to a violation of the policy.

Recommendations: We recommend that KRS Board trustees comply with all KRS Board policies and not use the trustee position to improve his or her professional interest. If the trustee's career is in the investment industry, extra caution is necessary to avoid the appearance of conflicts. We recommend trustees follow the KRS Board bylaws to refer all news media inquiries to the Executive Director and do not discuss matters that affect KRS or the Board generally with the news media. We also recommend that the KRS Board revise its Conflict of Interest and Confidentiality Policy to include specific penalties or a process to be followed when a trustee is found to have violated policy requirements or bylaws. We further recommend that trustee disciplinary actions taken as a result of policy violations be disclosed during a public KRS Board meeting and that the action be documented in the Board meeting minutes.

Finding 14: KRS Procurement Policy authorizes KRS to spend funds for employee prizes, gifts and service awards.

Testing a sample of KRS ProCard transactions for the period July 1, 2007 through December 31, 2010, revealed that KRS routinely purchased employee retirement gifts, prizes, and service awards for its staff. This practice is allowed by the KRS Procurement Policy and is exempted from competitive sealed bids. Regardless of whether KRS complied with its policy, these purchases are personal in nature and are not a necessary business expense that provides benefit to KRS members.

Recommendations: We recommend that the KRS Board revise its procurement policies to no longer allow pension funds to be spent on monthly prizes. In lieu of using pension funds for retirement gifts, receptions, or other service recognition awards, KRS employees should be limited to receiving a certificate or plaque. If KRS staff would like to continue providing these awards, prizes or gifts, the expense should be collected from personal funds rather than at the expense of KRS members.

Finding 15: KRS had no established method for employees and citizens to anonymously report concerns.

The KRS Fraud Management Policy established on May 21, 2009, did not include a process for individuals outside of KRS, such as citizens and contractors, to anonymously report concerns pertaining to potential fraud, waste, or abuse within KRS. The process established through the Fraud Management Policy is very specific to employees and how they may report matters through the structural hierarchy of KRS, with certain exceptions if reporting to a specific individual would create a conflict of interest. While this policy does state, "[t]he identity of any reporting individual and/or suspected individual will be kept confidential to the extent possible," the policy does not outline a means by which an employee or other individuals may report concerns without having to share any personal information.

Recommendations: We recommend the KRS Board create a multifaceted process through which KRS and its Board can effectively receive anonymous reports from individuals within and outside of its organization. While this may be accomplished through revising its current Fraud Management Policy, the expanded policy should ensure that the process is sufficiently independent to offset any risk of internal influence over the fraud investigation process. See Finding 9. We further recommend the KRS Board ensure that the process for anonymously reporting concerns is formally documented in KRS policies and properly disseminated to its employees and made available the public. The information should be easily accessible through the KRS internet website. We also recommend KRS consider including this information when issuing newsletters to its members. We finally recommend that the KRS Board include additional language in its policy to clearly document the employee protections that are available under the Kentucky Whistleblower Act.

Finding 16: Routine reporting to the Board is not sufficient.

While the KRS Board receives information from individuals and groups both inside and outside of its organization, certain operational information was not routinely reported, or in some cases was not reported at all. KRS staff does not routinely report budget-to-actual information to the KRS Board. The KRS Board is also not presented with any information related to investment expenditures, which includes the travel expenses incurred by KRS Investment staff. The KRS Board was also not aware of the actual salaries being paid to staff until recently and only approved the KRS salary structure, annual pay raises, and incremental increases for KRS staff at the organizational level. In addition, it was found that healthcare administrative expenses are not included in the budget provided to the KRS Board or the General Assembly.

Recommendations: We recommend that KRS include the administrative costs to operate the health insurance portion of the retirement system in the KRS budget that is approved by the Board and General Assembly. We recommend that the KRS Board require staff to provide to the Board quarterly budget-to-actual expenditure reports. This report should be detailed by budget line item and should include an explanation for significant variances. We also recommend that the KRS Board require staff to provide to the Board quarterly investment expenditure reports. This report should present investment costs by expense category so that specific investment activities can be monitored by the KRS Board. Expenses paid from the pension and insurance fund should be monitored by the KRS Board. We further recommend that the KRS Board require staff to provide to the Board an annual report of executive staff salaries. The report should provide their salaries for a three-year period to allow for comparative data and fully disclose salary data. The KRS Board should request additional salary data on all KRS staff as needed in their review of the KRS salary structure.

Finding 17: KRS does not budget for investment administrative expenditures such as travel, education, and conferences.

KRS budgets for general administrative expenses: however, direct investment expenses are not included in the KRS budget approved by the KRS Board. By not including the investment expenses in the budget process, these expenses are not presented within specific activity categories. In addition, KRS does not maintain a comprehensive list of investment travel and meetings that could document the necessity and effectiveness of the costs incurred. Investment costs are allocated as expenditures from both the pension and insurance funds but only limited monitoring can be conducted by the KRS Board and its Investment Committee.

Recommendations: We recommend the KRS Board adopt a budget that includes certain investment related expenses such as travel, education, and conferences that are not already included in the KRS budget. This budget should be monitored by the KRS Board to document their awareness of the funds used for investment purposes. We also recommend KRS staff provide regular quarterly reports to the KRS Investment Committee and full Board of budget to actual investment expenditures. The reports should be formatted in a clear and concise manner to facilitate the committee members' review of these expenditures made from various pension and insurance funds. We also recommend that KRS ensure that personal trips taken in association with business travel be clearly identified and that leave balances be reduced as appropriate. The purpose of the daily travel, as stated on the travel voucher, should be an accurate and concise representation of the traveler's activity on that day. In addition, we recommend that KRS create a consolidated database to formally document meetings and costs incurred by KRS investment personnel. Staff should be appointed to record this information and maintain the database. Information on meetings, either local or out-of-state, should be provided in advance to ensure that all meetings are known and documented. The actual costs incurred for a meeting should be recorded in the database so that a complete record is maintained for monitoring and budget purposes. We further recommend that KRS provide regular reporting to its Investment Committee members detailing the investment meetings conducted and the costs incurred by KRS investment staff, including the CIO. This report should contain the date of the meeting, the purpose, the location, and the associated costs. This report should be presented for informational purposes to allow for discussion of the effectiveness of the meeting and to ensure additional accountability and transparency.

Finding 18: KRS Board meeting minutes were not completed in accordance with the Board bylaws.

In reviewing KRS Board meeting minutes for the period July 1, 2007 through December 30, 2010, we found several instances of meeting minutes not presented or amended in a timely manner as required under the Board's bylaws. The KRS Board of Trustees Statement of Bylaws and Committee Organization states, "[t]he Executive Director shall cause the minutes to be transcribed and presented for approval or amendment at the next regular meeting." During the time period under review, approximately nine out of 28 full KRS Board meetings and seven out of 22 Investment Committee meetings did not have the minutes transcribed, presented, or amended by the next regular meeting of those bodies.

Recommendations: We recommend that KRS staff ensure that KRS Board meetings and its committee meetings are transcribed in a timely manner as prescribed and required by the KRS Board bylaws. The appropriate number of KRS staff should be assigned the responsibility of transcribing the meeting minutes to ensure that there is adequate coverage based on the number and length of full KRS Board and committee meetings. The internal review process of the draft meeting minutes should also be evaluated to ensure that an effective and timely process is in place.

Finding 19: The KRS Board election and appointment process is inconsistent.

A review of KRS Board trustee requirements identified opportunities to make the KRS Board trustee election and appointment processes stronger and more consistent. Processes that could be strengthened include the application process, assurance of trustee qualifications, and disclosure of relevant information to members.

Recommendations: We recommend the same disclosure requirements and application process be followed for both appointed and elected KRS Board trustees. At a minimum, these requirements should include a current and detailed resume, a cover letter detailing the applicant's specific qualifications to be an effective KRS Board trustee, authorization for a background check, acknowledgement of any felonies, and a formal application. We recommend this information be provided by potential appointees and election candidates at the initiation of the application process or election process. To ensure a consistent process, we recommend KRS perform a background check of candidates for elected trustee. This check should be performed and the results distributed to the KRS trustees prior to considering candidates that will be placed on the election ballot. We recommend that the KRS Board document background, experience, and qualifications for each trustee on the website's "Meet the Board" page.

Finding 20: KRS bylaws do not limit the number of terms an individual may serve as Board Chair or Vice Chair.

The KRS Board bylaws state that the Chair and Vice Chair "may be elected to successive terms in office." This policy does not specify the number of successive terms that a Board Chair or Vice Chair can serve. The former KRS Board Chair served fourteen consecutive terms as Chair.

Recommendations: We recommend a maximum number of terms be established for an individual to successively serve as Board Chair or Vice Chair. If legislation is not passed, we recommend that the KRS Board vote to limit the terms of the Board Chair and Vice Chair. In selecting the term limit for the Board Chair, a balance is needed to ensure stability but to also rotate the concentration of power held by one individual.

Finding 21: Additional external audit services would assist the KRS Board in strengthening oversight of its operations.

The only type of audits conducted at the request of the KRS Board was a financial statement audit and no additional audits have been requested. During our review of audits performed of other state's pension plans, we noted various types of audits conducted that would be beneficial for KRS. Given the current economic condition and the tenuous financial positions of many public pension plans, including KRS, further examinations or reviews could be used to ensure the effectiveness of internal controls, compliance with investment policies, soundness of the internal audit function, and adherence to industry best practices.

Recommendations: We recommend that the KRS Board Audit Committee seek, at least periodically, more than just an external financial statement audit of the retirement system. With additional external audit services, the Board could obtain a more in-depth analysis of any function or aspect of the retirement system (administrative, investment, or benefit delivery), comparison of policies to practice, and gain valuable insight into how operations might be improved as well the best practices identified in other states.

Chapter 1
Introduction and Background

Examination Engagement and Scope

In August 2010, the Internal Auditor and Compliance Officer for the Kentucky Retirement Systems (KRS) presented a draft audit on the use of placement agents by KRS to both KRS Investment and Audit Committees. After much discussion among the committee members, the Audit Committee voted to approve the draft audit with the caveat that the Internal Auditor and Compliance Officer perform additional audit procedures to further examine the use of placement agents and document the results in a supplemental report. However, after the draft audit report was presented at the regularly scheduled KRS Board of Trustees (Board) meeting two days later, the Board voted unanimously to send the report back to the Audit Committee for further review.

In a letter dated August 23, 2010, the Kentucky Governor suggested to the now-former KRS Board Chair "that the Board of KRS request the Auditor of Public Accounts to conduct an independent review of the adequacy of the internal audit process and also determine if additional steps are needed from an independent perspective." The Governor also stated that the Auditor of Public Accounts (APA) "could conduct a thorough review of the KRS policies and make recommendations as needed for best practices to be implemented to strengthen and improve the oversight and operations of KRS to ensure the transparent and efficient use of financial resources."

On September 1, 2010, the Audit Committee held a special meeting. At that meeting, committee members voted to ask the APA to examine the use of placement agents at KRS rather than having KRS internal audit staff perform additional audit procedures. On the following day, the KRS Board Chair and the KRS Executive Director met with the APA to request a review of the Board's internal auditing process, as suggested by the Governor. Though no further action was taken by KRS to finalize the draft report, APA auditors reviewed the draft report and working papers during this examination. See Exhibit 1 for draft internal audit report.

On September 9, 2010, the U.S. Securities and Exchange Commission (SEC) opened an "informal inquiry" into KRS. A staff attorney for the SEC stated that "this inquiry is a non-public, fact-finding inquiry" and in a letter dated September 9, 2010 stated that it "should not be construed as an indication by the SEC or its staff that any violation of law has occurred, nor should it be considered as a reflection upon any person, entity, or security."

In an October 5, 2010 letter to the KRS Board Chair, the APA committed to perform a review of certain aspects of KRS. According to that letter, the purpose of this review was not to provide an opinion on financial statements or investment decisions, but to address the following objectives:

- Evaluate various KRS policies, internal controls, and other aspects of the KRS operation;
- Ensure the transparent, efficient use of financial resources; and,

- Make recommendations to strengthen and improve internal controls, as well as the oversight and operations of KRS.

Specific items to be scrutinized during the review included:

- KRS Board and committee structure;
- Policies governing the internal audit process and reporting to the KRS Board by staff;
- Business conduct, conflict of interest, and ethics policies;
- Procurement policies;
- Adequacy of current audits and financial reports; and,
- Use of "placement agents."

The scope of this review includes records, activities, and information for the period July 2007 through June 2010, unless otherwise specified; however, the time period of certain documents reviewed and various issues discussed with those interviewed may have varied.

While performing this examination, many changes in personnel occurred at both KRS and the KRS Board. The KRS Executive Director was removed by the KRS Board and a new Board Chair and Vice Chair were elected on April 7, 2011. Subsequently, committee assignments and KRS staff leadership changed as well. On April 12, 2011 the KRS General Counsel resigned effective May 2, 2011. See Exhibit 2 for a more detailed timeline of these and other significant KRS events that occurred prior to or during our examination period.

Methodology

Thousands of documents, including emails, reports, and policies, were supplied by the KRS staff, KRS Board, and concerned citizens of the Commonwealth in response to our announced involvement in this audit and our request for information. These and other documents, including those KRS provided to the SEC, were reviewed and analyzed in relation to the objectives of the review. The results from this review are discussed in detail in Chapter 3.

To address the audit objectives, the APA conducted interviews, reviewed documents, and tested expenditures, including travel reimbursements and credit card transactions. For this review, the APA interviewed 30 individuals including:

- 10 current and former members of the Board of Trustees;
- 12 current staff members of KRS (staff interviewed included Chief Operating Officer/now Interim Executive Director, Chief Investment Officer, Director of Alternative Assets Investing/former Acting Chief Investment Officer, Director of Equity Assets Investing, Director of Fixed Assets Investing, Director of Internal Audit, Compliance Officer, Information Security Officer; and Director of Accounting/former Director of Internal Audit);

- Two former staff members of KRS (Executive Director and General Counsel);
- Two consultants to KRS;
- External auditor for KRS;
- Executive Director of the Executive Branch Ethics Commission; and,
- Securities and Exchange Commission (SEC) investigator.

The APA attempted to interview the former Chief Investment Officer (CIO) and the Placement Agent who was involved in the most investments during the period under review by the internal audit staff. While the APA spoke briefly with the former CIO over the phone, both individuals declined to be interviewed.

The APA reviewed travel reimbursements for fiscal years (FY) 2008, 2009, and 2010 to determine the presence of required documentation, reasonableness of expenditures, and compliance with KRS policy. The travel expenditures were also tested to determine if spouse travel was incurred and reimbursed.

The APA also reviewed credit card statements from FY 2008, FY 2009, FY 2010, and FY 2011 through February 21, 2011. A judgmental sample of credit card expenditures was selected and reviewed to determine whether purchases were made in accordance with KRS policy. Our testing included a comparison of credit card expenditures to travel vouchers for various purposes including to determine whether staff was reimbursed for actual meals and per-diem on the same day.

Authority and Membership

KRS administers three retirement systems which are qualified defined benefit plans under Section 401(a) of the Internal Revenue Code. The systems were established in the 1950s to provide a pension that, when coupled with Social Security, would provide the retired public career employee with a sustained level of income. The three systems serve active members (those currently employed and actively contributing to their plans), inactive members (former employees who are not actively contributing to their plans and are not receiving benefits), and retired members (former employees who are receiving benefits). As of June 30, 2010, KRS served a combined total of 318,981 active, inactive, and retired members through the three systems. The composition of the members participating in each system as of June 30, 2010, is as follows:

- Kentucky Employees Retirement System (KERS) – 123,138;
- County Employees Retirement System (CERS) – 193,690; and,
- State Police Retirement System (SPRS) – 2,153.

KERS, created in 1956 by the Kentucky General Assembly, is governed by KRS 61.510 – 61.705. When the first actuarial valuation of KERS was completed as of June 30, 1957, there were 16,000 employees participating in KERS and the plan had assets of $2.8 million. As of June 30, 2010, the plan had assets of nearly $4.6 billion and 52,195 employees from 380 agencies were actively participating in KERS. The following categories of agencies typically participate in KERS. The number of agencies participating for each agency category is noted in parentheses:

- State agencies reporting through state payroll (169);
- Other agencies such as universities, mental health boards, health departments (144);
- Special districts and boards (4);
- Child support offices (county attorneys) (60); and,
- Other state-administered retirement systems (3).

CERS, established in 1958 with 2,617 employees participating in the system, is governed by KRS 78.510 – 78.852. No actuarial valuation of CERS was conducted until June 30, 1960 because the statutes did not authorize retirements from the system prior to July 1, 1960. As of June 30, 2010, the plan had assets of approximately $8 billion and 96,298 employees from 1,404 agencies were participating in the system. The following types of agencies typically participate in the CERS. The number of agencies participating for each type is noted in parentheses:

- Area Development Districts (13);
- Boards of Education (174);
- Cities (218);
- County Attorneys (67);
- County Clerks (15);
- County Government Agencies (260);
- Fire Departments (71);
- Hospitals (3);
- Jailers (9);
- Libraries (83);
- Planning Commissions (11);
- Police Departments (91);
- Police & Fire Departments (combined) (61);
- Sanitation Districts (6);
- Sheriff Departments (53);
- Special Districts and Boards (161);
- Utility Boards (104); and,
- Urban County Government Agencies (4).

SPRS, established in 1958 with 415 uniformed state troopers, is governed by KRS 16.505 – 16.652. The first actuarial valuation of SPRS was conducted on June 30, 1959. As of June 30, 2010, SPRS had over $369 million in plan assets and 961 employees contributing to it. All regular full-time uniformed officers of the Department of Kentucky State Police participate in the SPRS.

Member Benefits

Each system offers a defined benefit pension, as well as health insurance benefits, to its participating members. Upon retirement, a defined benefit plan pays lifetime monthly benefits based on a formula established by statute that takes into account an employee's years of service and the highest average compensation of a three or five year period. In contrast, a defined contribution plan, such as a 401(k) plan, pays benefits solely on the amount of money paid into the plan and the investment earnings of that money. There is no guaranteed benefit with a defined contribution plan.

Under a defined benefit pension plan, public employees are "promised" certain benefits based on years of service and salary amounts. This promise is considered an inviolable contract of the Commonwealth, which cannot be reduced for any current employee or retiree and as such it is protected by state law and also the Kentucky and U.S. Constitutions. According to Blue Ribbon Commission's final report dated December 2007, "Kentucky is one of a few states that have an inviolable contract to provide both pension and healthcare benefits to its retirees. The body of law that defines and supports this "contract" is argued to be among the strongest, most clearly delineated in the entire country. Several Kentucky Attorney General opinions and at least one Kentucky Supreme Court case (Jones v. KRS Board of Trustees) have addressed the inviolability of Commonwealth's contract."

While the retirement contract is inviolable, specific details and calculations have been altered in recent years by the Kentucky General Assembly. The following actions taken by the General Assembly regarding changes to member benefits and contribution requirements provide a snapshot of various ways the system has been impacted, both positively and negatively, by these changes.

- In 1998, the benefit factor was increased from 1.97 percent to 2.2 percent for employees who retire between February 1, 1999 and January 31, 2009 with at least twenty years of service credit.
- In 2001, the General Assembly amended the final compensation formula used for determining benefits at the time of retirement from the five fiscal years of service with the highest average monthly salaries to the three fiscal years of service with the highest average monthly salaries. This change affected only those non-hazardous KERS and CERS employees who: retired between August 1, 2001 and January 1, 2009; had a minimum of 27 years of service; and whose age and years of service totaled at least 75.

- In 2003, the General Assembly passed House Bill 430 that required employees hired on July 1, 2003 or after to earn at least 120 months of service credit before they will be eligible for insurance benefits at retirement. Prior to the passage of this bill, employees became eligible for 25 percent of insurance benefits within 60 months of service credit. However, employees hired before, on, and after this date, earn the same percent of insurance benefits by working 120 months (50 percent), 180 months (75 percent), and 240 months (100 percent).
- In 2004, the General Assembly passed House Bill 290 that changed the benefit factor to 2.0 percent for employees who begin participating in CERS in a non-hazardous position on or after August 1, 2004. Due to the provisions in 2003's House Bill 430 that allow the General Assembly to alter the level of insurance benefits for employees hired on or after July 1, 2003, House Bill 290 made additional changes to insurance benefits for employees who began participating in the retirement systems on or after that date. Instead of a guaranteed payment of a percent of insurance benefits, non-hazardous employees will earn an insurance contribution of $10 per month for each year of earned service, hazardous duty employees will earn an insurance contribution of $15 per month for each year of earned hazardous duty service, and no benefits will be received by those employees working less than 10 years.
- In 2005, the General Assembly passed House Bill 267 that incorporated the KERS and SPRS employer contribution rate reductions into the Executive Branch Budget that were passed during the 2004 Special Session of the legislature.
- In 2008, the General Assembly passed House Bill 1 (the Pension Reform Bill) during a Special Session of the legislature. House Bill 1, which mostly affected new employees, created: a new benefit tier for employees who began participating in the KRS after September 1, 2008; a one percent health insurance contribution by employees who began participation in the KRS after September 1, 2008; an increase in the number of years required for full retirement for new employees to 30; and new vesting requirements for health care coverage to 10 years. Two major changes impacted current employees and retirees: clarification of rules for retiring and then returning to work for a participating employer after September 1, 2008; and a one and one-half percent limit on the annual Cost of Living Adjustment (COLA).
- In 2009, the General Assembly passed House Bill 117 that required the KRS Board to set rates for CERS employers that phased-in an actuarially recommended increase in the health insurance trust contribution over a ten-year period, rather than over the five-year period that was previously adopted by the KRS Board in 2006 that first became effective in FY 2008.

Employee and Employer Contributions

In KERS, CERS, and SPRS both the employee and the employer contribute a percent of their gross wages, referred to as creditable compensation, to KRS. The employee contribution rate is a constant percent of pre-tax salary, but the rate paid depends on whether the employee is classified as working in a non-hazardous or hazardous position, as defined by KRS 61.592. Non-hazardous employees are statutorily required to contribute five percent of the pre-tax salary to their pension benefit, while hazardous employees contribute eight percent on a pre-tax basis.

Due to the passage of House Bill 1 during the 2008 Special Session of the General Assembly, all employees hired with an initial participation date on or after September 1, 2008 must contribute an additional one percent of their pre-tax income toward retiree health insurance benefits. These monies are deposited in a 401(h) account within the pension trust.

Employer contributions are calculated annually and approved by the KRS Board based on an annual actuarial valuation and include the normal cost of pension and insurance benefits plus an amortized contribution toward the unfunded liability of the pension and insurance trusts. Employer contributions also include an administrative fee that is used to pay annual operating expenses of KRS.

Each employer is statutorily required to contribute at the rate determined by the KRS Board; however, KERS and SPRS employer rates are subject to approval by the Kentucky General Assembly through the adoption of the biennial Executive Branch Budget. The employer contribution rate for CERS may also be altered by legislation enacted by the General Assembly.

In recent years, the General Assembly has routinely suspended KRS 61.565 in the budget bill in order to fund the employer contribution at a lower rate than the amount recommended by the KRS Board for KERS and SPRS employers. Also, the rate recommended for CERS employers was reduced in FY 2009, FY 2010, and FY 2011 due to passage of House Bill 1 during the 2008 Special Session and House Bill 117 during the 2009 Regular Session of the General Assembly. Rate reductions contributed to inadequately funded employer contributions. When the employer contributions are inadequately funded, KRS pension funds meant to pay future employee benefits must be spent to pay current benefits. Such continued action, without correction, leads to an unsustainable pension plan.

The following table lists both the employer contribution rate budgeted by the Kentucky General Assembly and the actuarially recommended rate set by the KRS Board.

Table 1: History of Employer Contribution Rates

		FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
KERS Non-Hazardous	**Budgeted Rate**	5.89	3.76	5.89	5.89	5.89	7.75	8.5	10.01	11.61	16.98
	Recommended Rate by KRS	5.89	5.89	7.53	10.29	13.62	17.13	48.37	28.60*	31.29*	38.58
KERS Hazardous	**Budgeted Rate**	18.84	17.60	18.84	18.84	18.84	22.00	24.25	24.35	24.69	26.12
	Recommended Rate by KRS	18.84	18.84	18.84	19.47	21.59	23.32	47.11	34.78	35.54	34.37
CERS Non-Hazardous	**Budgeted Rate**	6.41	6.34	7.34	8.48	10.98	13.19	16.17	13.50	16.16	16.93
	Recommended Rate by KRS	6.41	6.34	7.34	8.48	10.98	13.19	16.17*	15.58*	20.19*	19.81
CERS Hazardous	**Budgeted Rate**	16.28	16.28	18.51	22.08	25.01	28.21	33.87	29.50	32.97	33.25
	Recommended Rate by KRS	16.28	16.28	18.51	22.08	25.01	28.21	33.87*	31.91*	61.87*	40.06
SPRS	**Budgeted Rate**	21.58	17.37	21.58	21.58	21.58	25.50	28.00	30.07	33.08	45.54
	Recommended Rate by KRS	21.58	21.58	21.58	28.08	34.83	42.30	120.0	60.14*	43.36*	85.63

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp. 148 & 189, respectively).
* KRS recommended rate varied from rate recommended by actuary.

Plan Assets

KRS administers both a pension plan and an insurance plan for each of the three systems. The plans' funds are established as trusts that are used to fund monthly pension and health care payments to, and on behalf of, retirees. In addition, separate trusts have been established for hazardous and non-hazardous employees within KERS and CERS. Although the assets for the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to the members of that plan, in accordance with the provisions of KRS Sections 16.555, 61.570, and 78.630. Table 2 through Table 5 illustrate the total net assets in KRS and the net assets for each system.

Table 2: Net Plan Assets of Kentucky Retirement Systems (Dollars in Thousands)

Fiscal Year Ending	Pension	Insurance	Total
June 30, 2001	$11,763,200	$1,078,475	$12,841,675
June 30, 2002	10,906,841	1,196,375	12,103,216
June 30, 2003	10,913,548	1,343,799	12,257,347
June 30, 2004	11,879,631	1,701,842	13,581,473
June 30, 2005	12,405,191	1,928,605	14,333,796
June 30, 2006	12,950,226	2,201,187	15,151,413
June 30, 2007	14,228,184	2,731,217	16,959,401
June 30, 2008	12,955,383	2,647,920	15,603,303
June 30, 2009	9,881,697	2,056,272	11,937,969
June 30, 2010	10,540,440	2,425,987	12,966,427

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.132 &173, respectively).

Table 3: Net Plan Assets of Kentucky Employees Retirement System (Dollars in Thousands)

Fiscal Year Ending	Non-Hazardous			Hazardous		
	Pension	Insurance	Total	Pension	Insurance	Total
June 30, 2001	$5,484,564	$396,254	$5,880,818	$305,544	$107,592	$413,136
June 30, 2002	5,005,191	465,665	5,470,856	301,800	109,769	411,569
June 30, 2003	4,929,319	487,071	5,416,390	320,513	125,522	446,035
June 30, 2004	5,258,995	587,681	5,846,676	366,568	162,127	528,695
June 30, 2005	5,362,631	610,901	5,973,532	398,308	188,871	587,179
June 30, 2006	5,440,133	612,643	6,052,776	437,030	223,523	660,553
June 30, 2007	5,773,157	663,558	6,436,715	510,775	280,886	791,661
June 30, 2008	5,056,869	574,479	5,631,348	484,438	269,300	753,738
June 30, 2009	3,584,601	365,367	3,949,968	388,951	219,500	608,451
June 30, 2010	3,504,501	368,799	3,873,300	443,606	271,240	714,846

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.132 & 173, respectively).

Table 4: Net Plan Assets of County Employees Retirement System (Dollars in Thousands)

Fiscal Year Ending	Non-Hazardous			Hazardous		
	Pension	Insurance	Total	Pension	Insurance	Total
June 30, 2001	$4,397,347	$331,067	$4,728,414	$1,211,155	$173,636	$1,384,791
June 30, 2002	4,126,756	365,333	4,492,089	1,144,349	187,534	1,331,883
June 30, 2003	4,175,825	435,500	4,611,325	1,168,776	223,168	1,391,944
June 30, 2004	4,613,335	563,877	5,177,212	1,305,012	297,737	1,602,749
June 30, 2005	4,893,600	668,485	5,562,085	1,411,246	360,940	1,772,186
June 30, 2006	5,191,377	813,251	6,004,628	1,528,845	441,279	1,970,124
June 30, 2007	5,812,936	1,084,043	6,896,979	1,754,935	570,156	2,325,091
June 30, 2008	5,431,735	1,105,945	6,537,680	1,644,982	576,414	2,221,396
June 30, 2009	4,331,010	894,490	5,225,500	1,320,560	483,233	1,803,793
June 30, 2010	4,820,490	1,094,821	5,915,311	1,506,894	586,614	2,093,508

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.132 & 173, respectively).

Table 5: Net Plan Assets of State Police Retirement System (Dollars in Thousands)

Fiscal Year Ending	Pension	Insurance	Total
June 30, 2001	$364,592	$69,926	$434,518
June 30, 2002	328,744	68,074	396,818
June 30, 2003	319,115	72,538	391,653
June 30, 2004	335,721	90,420	426,141
June 30, 2005	339,406	99,408	438,814
June 30, 2006	352,841	110,491	463,332
June 30, 2007	376,381	132,574	508,955
June 30, 2008	337,359	121,782	459,141
June 30, 2009	256,575	93,682	350,257
June 30, 2010	264,949	104,511	369,460

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.132 & 173, respectively).

Funding Levels and the Unfunded Actuarial Liability

Funding for plan benefits is provided through three sources: the contributions paid by employees, the contributions paid by employers, and the return on investments. Beginning in FY 1993, the General Assembly has not fully funded KERS and SPRS for 12 out of 17 years. The enacted employer contribution rates beginning in FY 2003 for these systems have been consistently and significantly less than the recommended rates, contributing to a decrease in net assets for each plan within the two systems. This situation has resulted in an unfunded liability to meet future retirement costs based on actuarial projection.

The progress toward achieving a fully funded pension plan can be measured by the relationship between the actuarial value of fund assets to the actuary's projection of the fund liability to pay the benefits earned by employees. This relationship is known as the funding level. To calculate the funding level, the actuarial liability of benefits earned to date is divided by current assets. If the funding level is less than 1.00 (or 100 percent), the liabilities for benefits already earned by employees and retirees is greater than the assets on hand to pay them, which is an unfunded liability. Given the 2010 funding level of the KERS non-hazardous pension plan is 38.3 percent, for every dollar of pension benefits earned by the employees, the KERS Pension Trust has 38.3 cents in assets available to pay out earned benefits to employees. This means that KRS only has the assets to pay out 38.3 percent of the benefits already earned by employees.

The total funding levels for the ten pension and insurance funds, determined as of June 30, 2010, are presented in Table 6; however, Table 7 through Table 9 illustrate the prominent trend of decreased funding levels during recent years. A decreasing trend in the funding level impacts the financial viability of the system. Due to the compounding effect, the impact of decreasing funding levels will be much greater over an extended period.

Table 6: Total KRS Pension and Insurance Funding Levels as of June 30, 2010

System	Pension Funding Level	Insurance Funding Level
KERS Non-Hazardous	38.3%	10.6%
KERS Hazardous	73.1%	63.7%
CERS Non-Hazardous	65.6%	40.9%
CERS Hazardous	65.5%	41.4%
SPRS	49.7%	27.9%

Source: 2010 Comprehensive Annual Financial Report for Kentucky Retirement Systems (pp.128-129).

Table 7: History of Funding Levels for KERS

Valuation Date	Non-Hazardous		Hazardous	
	Pension Fund	Insurance Fund	Pension Fund	Insurance Fund
6/30/01	125.7%	25.4%	126.8%	55.7%
6/30/02	110.4%	27.3%	116.9%	57.4%
6/30/03	97.4%	26.5%	108.1%	53.5%
6/30/04	85.1%	25.7%	98.4%	52.3%
6/30/05	73.6%	22.7%	92.3%	48.6%
6/30/06	60.0%	7.8%	84.1%	34.3%
6/30/07	56.9%	11.9%	83.6%	49.8%
6/30/08	52.5%	11.1%	81.3%	53.2%
6/30/09	45.0%	11.9%	74.5%	61.4%
6/30/10	38.3%	10.6%	73.1%	63.7%

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.104-105 & 143-144, respectively).

Table 8: History of Funding Levels for CERS

Valuation Date	Non-Hazardous		Hazardous	
	Pension Fund	Insurance Fund	Pension Fund	Insurance Fund
6/30/01	146.3%	20.7%	124.5%	27.4%
6/30/02	129.6%	22.8%	111.9%	30.0%
6/30/03	119.7%	23.9%	97.8%	28.8%
6/30/04	105.1%	24.0%	88.8%	30.3%
6/30/05	94.0%	23.8%	80.9%	28.0%
6/30/06	83.6%	16.9%	75.0%	21.9%
6/30/07	82.1%	28.8%	74.2%	31.2%
6/30/08	78.5%	32.6%	72.9%	34.7%
6/30/09	71.4%	39.6%	67.9%	40.9%
6/30/10	65.6%	40.9%	65.5%	41.4%

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.106-107 & 145-146, respectively).

Table 9: History of Funding Levels for SPRS

Valuation Date	Pension Fund	Insurance Fund
6/30/01	128.1%	50.5%
6/30/02	115.3%	52.5%
6/30/03	99.6%	49.2%
6/30/04	88.0%	48.9%
6/30/05	77.1%	42.8%
6/30/06	66.6%	18.1%
6/30/07	63.7%	26.6%
6/30/08	59.8%	27.9%
6/30/09	54.8%	33.9%
6/30/10	49.7%	27.9%

Source: 2006 and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.108 & 147, respectively).

Many factors have contributed to decreasing funding levels for the pension and insurance funds. These factors include, in no particular order:

- The General Assembly significantly and consistently funded the Employer contribution at less than the recommended rate since FY 2003;
- Major economic recessions, which have driven investment returns below the assumed rates of return;
- Higher than anticipated retirement rates due to early retirement incentive windows during the 1990s and early 2000s;
- Medical inflation rates in excess of estimated rates;
- Increased expenditures for unfunded retiree Cost of Living Allowance adjustments (COLA);
- Changes in the actuarial assumptions; and,
- Application of GASB Statement 43 requirements.

According to the Pew Center's recent report, *The Widening Gap*, as of FY 2009, 31 states were below the 80 percent funded threshold and 19 states had set aside no funds to cover retiree health care benefits. Based on FY 2009 data, the Pew Center estimates the Kentucky overall pension liability to be funded at 58 percent. While New Hampshire also had a funding level of 58 percent, only three states (Illinois, Oklahoma, and West Virginia) had a lower percent of funding towards their pension liability than Kentucky's funding level. Using that same data, the Pew Center also estimates that Kentucky's retiree health care liability was funded at 15 percent. Although only seven states had funded their health care liabilities at higher levels, a funding level of 15 percent is significantly low.

Addressing the Unfunded Actuarial Liability

Actions Taken by KRS

In 2009, KRS took action to address a portion of the unfunded liability of the insurance funds. KRS entered into a contract with the Centers for Medicare and Medicaid Services (CMS) to establish an Employee Group Waiver Plan for pharmacy benefits for Medicare-eligible retirees. This contract allows KRS to apply the full amount of the drug subsidy received from CMS toward its unfunded liability for medical benefits. KRS staff reported that, in its first full year under this program, this contract led to an immediate reduction of over $1.7 billion to the unfunded insurance liability for the fiscal year ended June 30, 2009. Even with such a large reduction, the actuarial liability for the five insurance funds remained at $8.55 billion, as of June 30, 2010.

Actions Taken by the Governor and General Assembly

In February 2007, the Kentucky Governor created, by Executive Order, the 24-member Blue Ribbon Commission on Public Employees Retirement Systems (Blue Ribbon Commission). The Blue Ribbon Commission was charged with evaluating all aspects of KRS and the Kentucky Teachers Retirement System (KTRS) and developing a plan to address the current unfunded liabilities of the systems to ensure the obligation to public retirees can be fulfilled. The findings of the Blue Ribbon Commission were presented to the legislature on January 18, 2008, and incorporated into a pension reform bill, House Bill 600, during the 2008 Regular Session. House Bill 600 was changed through a Senate Committee Substitute and was eventually sent to a free conference committee. However, a compromise was not reached and the bill failed in committee.

In the 2008 Special Session of the Kentucky General Assembly, the legislators passed a pension reform bill, House Bill 1, that included a schedule to increase employer contributions each year starting in FY 2011, until reaching the full annual required contribution (ARC) in 2025 for KERS non-hazardous, in 2019 for KERS hazardous, and in 2020 for the SPRS plans.

With the passage of the 2010 - 2012 Executive Branch Budget Bill, the Governor and the General Assembly honored the schedule established in the pension reform bill of 2008 by increasing the employer contribution requirement in the current biennium, despite a roughly $1 billion budget shortfall. Due to the difficult financial and budget issues, this funding schedule will continue to be a challenge for future governors and members of the General Assembly. To honor this commitment, the employer contribution rates must continue to increase over the next 15 years until the full contribution rate is reached in 2025.

Actions Taken in Other States

Around the nation, other states have also faced large unfunded liabilities concerning the cost of public employee pensions and retiree health care benefits amid declining rates of return in the marketplace. The following table shows, by year, what type of actions other states have taken towards pension reform since 2001.

Table 10: State Pension Reforms for the Period of 2001 Through 2010

State	Actions Taken		
	Reduced Benefits Paid	Increased Employee Contributions	Both
Alaska	2005		
Arizona	2010	2004; 2005; 2008	
Arkansas			2005
California	2007; 2010		
Colorado	2004; 2006		
Connecticut	2007		
Delaware	2002		
Georgia	2008; 2009		
Hawaii		2004	
Illinois	2003; 2005; 2010		
Iowa	2002	2008	2006; 2010
Kansas			2007
Kentucky			2008
Louisiana	2003; 2006; 2009	2010	2005
Maryland		2006	
Massachusetts	2009		
Michigan	2010		
Minnesota		2001; 2005	2006; 2010
Mississippi	2007		2010
Missouri	2007		2010
Nebraska		2004; 2006; 2009	2005
Nevada	2009		
New Hampshire	2008	2009	
New Jersey	2008; 2010	2007	
New Mexico	2010	2003	2005; 2009
New York	2009		
North Dakota	2005; 2007		
Oklahoma		2003; 2005; 2009	
Oregon			2003
Pennsylvania		2001	
Rhode Island	2005; 2009; 2010		
South Carolina		2005	
South Dakota	2004; 2010		
Texas		2007	2005; 2009
Utah	2010		
Vermont			2008; 2010
Virginia			2010
Washington		2003; 2005	
Wyoming	2006	2008; 2010	

Source: Created by the APA, based on information provided by the Pew Center (http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=61599).

KRS Board of Trustees

Under the provisions of KRS 61.645, the KRS Board administers the KERS, CERS, and SPRS. The Board is responsible for the collection and investment of contributions to these three systems. Trustees of the Board are considered fiduciaries and are required to administer the funds in the sole interest of the members and beneficiaries of the systems. According to KRS 61.645(15)(B), a Board trustee "exercises the care an ordinary prudent person in a like position would exercise under similar circumstances."

In addition, the KRS Board bylaws identify the trustees' responsibilities to include the following actions:

- Make bylaws;
- Appoint an Executive Director and fix the Executive Director's salary;
- Fix the salaries of employees;
- Act on contracts for rental of office space and professional services including, but not limited to, the auditor, actuary, legal counsel, medical examiners, and hearing officers;
- Act on legislative and regulatory changes proposed by the staff of the retirement systems;
- Ratify the audited financial statements;
- Ratify the actions of its Committees;
- Act on the recommendations of the actuary and adopt actuarial assumptions and contribution rates;
- Ratify the payment of benefits;
- Adopt contribution rates toward medical insurance premiums;
- Provide oversight concerning programs and services for members, retirees, beneficiaries, and participating employers;
- Select candidates for each trustee ballot; and,
- Refer all news media inquiries to the Executive Director and do not discuss matters that affect KRS or the Board generally with the news media.

Board Structure & Composition

The KRS Board is composed of nine trustees. Per KRS 61.645, the nine trustees are selected as follows:

- Two members or retirees of KERS elected by KERS members and retirees;
- Two members or retirees of CERS elected by CERS members and retirees;
- One SPRS member or retiree elected by SPRS members and retirees;
- Three members appointed by the Governor; and,
- Personnel Cabinet Secretary, as long as he/she occupies the position.

As an additional requirement, the 2010 General Assembly passed House Bill 146 that requires two of the three trustees appointed by the Governor have "investment experience," as defined in KRS 61.645. Prior to 2010, there was a requirement in this statute for one of the Governor's appointees to be knowledgeable about the impact of pension requirements on local governments.

The current trustees of the KRS Board and how they were selected is as follows:

- Bobby D. Henson – elected by KERS;
- Susan Smith – elected by KERS;
- Vince Lang – elected by CERS;
- Robert Wilcher – elected by CERS;
- Randy Overstreet – elected by SPRS;
- Jennifer Elliott – Governor appointed;
- Thomas Elliott – Governor appointed;
- Christopher Tobe – Governor appointed; and,
- Tim Longmeyer – ex-officio Personnel Cabinet Secretary.

KRS Board trustees serve a term of four years. A term year runs from April 1 of each calendar year through March 31 of the following year. After the passage of House Bill 1 during the 2008 Special Session of the Kentucky General Assembly, elected Board trustees could serve no more than three consecutive four year terms. However, those same individuals are eligible for re-election after an absence of four years from the Board. This provision applied to future Board trustees and was not applied retroactively to elected trustees on the Board at that time.

KRS Board trustees, who do not receive a salary from the Commonwealth, receive compensation of $80 for each day they are in session or on official duty. Any actual and necessary expenses incurred by the trustees are also paid by KRS. Regular quarterly meetings are held on the third Thursday of February, May, August, and November. According to the KRS Board bylaws, "special meetings shall be held upon the call of the Chair, Executive Director, or upon the request of five trustees of the Board."

The annual meeting of the KRS Board is held on the first Thursday of each Board year. At the annual meeting, the trustees elect the KRS Board Chair and Vice Chair. At the April 7, 2011, KRS Board meeting, the trustees elected Jennifer Elliott as the new Board Chair replacing Randy Overstreet who served as Board Chair for the last 14 consecutive years. Thomas Elliott, not related to Jennifer Elliott, was elected as the new Vice Chair.

Committee Structure

The standing committees of the KRS Board include the Administrative Appeals Committee, Disability Appeals Committee, Audit Committee, Investment Committee, Legislative and Budget Committee, Human Resources Committee, and the Retiree Health Plan Committee.

The Administrative Appeals Committee ensures that retirement laws are administered impartially and uniformly and that the actions of the retirement systems were correct and fair under the applicable statutes and regulations. The committee makes final rulings on appeal from administrative decisions or actions of KRS.

The Disability Appeals Committee is responsible for ensuring that the disability retirement laws are administered impartially and uniformly and approving benefits for members who apply for disability retirement and qualify under the applicable statutes. The committee grants or denies disability retirement awards to applicants upon appeal.

The Audit Committee acts on behalf of the KRS Board in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control, the internal and external audit processes, and the process for monitoring compliance with laws, regulations, and the code of conduct.

The Investment Committee acts on behalf of the KRS Board on investment related matters to assure the prudent investment of KRS funds. The members of this committee work to achieve the long-term funding goals established in the Board's Statement of Investment Policy.

The Legislative and Budget Committee reviews the retirement systems administrative budget and recommends additions or reductions in specific program areas or budgetary items. The members of the committee also review and recommend statutory changes to the KRS Board related to the administration of benefits and compliance with federal law. The members determine which changes are in the best interests of the retirement systems.

The Human Resources Committee assists the Executive Director and the KRS Board in attracting and retaining a competent, creative, and motivated workforce at the retirement systems.

The Retiree Health Plan Committee assists the KRS Board in providing a group hospital and medical insurance plan for present and future recipients of a retirement allowance from KRS as required by KRS 61.702.

In addition to the standing committees, the current Board Chair recently established two ad hoc committees – the Executive Director Search Committee and the Legal, Compliance, and Governance Committee. The Board Chair specified the duties and responsibilities of both committees in a document circulated to all KRS trustees and executive staff. Those duties and responsibilities are as follows for the two ad hoc committees:

The duties and responsibilities of the Executive Director Search Committee shall be: (1) to develop an RFP for a national executive search firm with expertise in recruiting top officers to public pension systems; (2) to evaluate responses to the RFP and select the most suitable vendor; (3) to interview potential candidates for the position of Executive Director and make recommendations to the Board of Trustees; and (4) to take all other necessary steps to fulfill its mission to recruit a new Executive Director of the Kentucky Retirement Systems. The members of the Board of Trustees on this ad hoc committee shall all have full voting rights. While the staff advisory members will not have official voting rights, their full participation is requested and encouraged.

The duties and responsibilities of the Legal, Compliance & Governance Committee shall be: (1) to oversee the legal and compliance function of the Kentucky Retirement Systems; (2) to make recommendations to the full Board of Trustees for the amendment of existing and/or development of new governance documents and policies of the Kentucky Retirement Systems; (3) to develop any RFPs for legal and compliance professional services and select the most suitable vendor for such services; (4) to evaluate any reports concerning the Kentucky Retirement Systems which may be issued by state or federal agencies and to make recommendations to the Board of Trustees with respect to any actions suggested or required by such report; and (5) to take all other necessary steps to fulfill its mission to oversee the legal, compliance, and governance of the Kentucky Retirement Systems.

At the start of each term year of the KRS Board, the Board Chair, unless otherwise determined by the Board, makes all committee assignments and appoints the Committee Chair. In addition, each committee may elect a Vice Chair from among its members by a majority vote of its membership. Committee members serve concurrently with the Board Chair. Committee assignments and Committee Chair appointments for the 2011-2012 Board term are shown in the table below.

Table 11: KRS Board of Trustees Committee Assignments for 2011-2012

Board Trustee	DAAC	Audit	Investment	Legislative and Budget	Human Resources	Retiree Health Plan	Ad Hoc: Executive Director Search	Ad Hoc: Legal, Compliance, and Governance
J. Elliott		X	X			Chair	X	Chair
T. Elliott			Chair	X	Chair	X	X	
Henson		X				X	X	
Lang	X		X	X			X	X
Longmeyer		X	X	Chair		X	X	X
Overstreet				X	X		X	
Smith	X				X	X	X	
Tobe		X	X	X			X	
Wilcher	Chair	Chair			X		Chair	X

Source: Auditor of Public Accounts based on information provided by the Kentucky Retirement System's current Board Chair.

KRS Agency Staff

As of April 30, 2011, KRS employed 251 full-time workers. Over the last 13 years, the actual number of full-time employees has increased 103 percent. The following table depicts the total number of KRS employees and the changes between the current and previous year's totals starting in FY 1998 and ending with FY 2010.

Table 12: Total Headcount for Full-Time Employees at KRS

Fiscal Year End	Total Number of Employees	Increase Since Previous Fiscal Year End
6/30/1998	123	--
6/30/1999	160	30%
6/30/2000	176	10%
6/30/2001	183	4%
6/30/2002	210	15%
6/30/2003	217	3%
6/30/2004	232	7%
6/30/2005	240	3%
6/30/2006	242	1%
6/30/2007	240	-1%
6/30/2008	244	2%
6/30/2009	251	3%
6/30/2010	250	0%

Source: Auditor of Public Accounts based on information provided by the Kentucky Retirement System.

During this time period, the actual number of employees had its highest increases during the months of July 1998 (123 to 145) and December 1999 (160 to 180).

On December 1, 2002, all employees of KRS were removed from the state personnel system and transferred to an internal personnel system adopted by the KRS Board. However, many of the benefits, rights, and privileges from the state personnel system were maintained, such as participation in the state insurance program and the deferred compensation system, types of leave, and personnel appeal rights.

Executive Staff

According to the KRS Board's bylaws, the Executive Director has the following responsibilities:

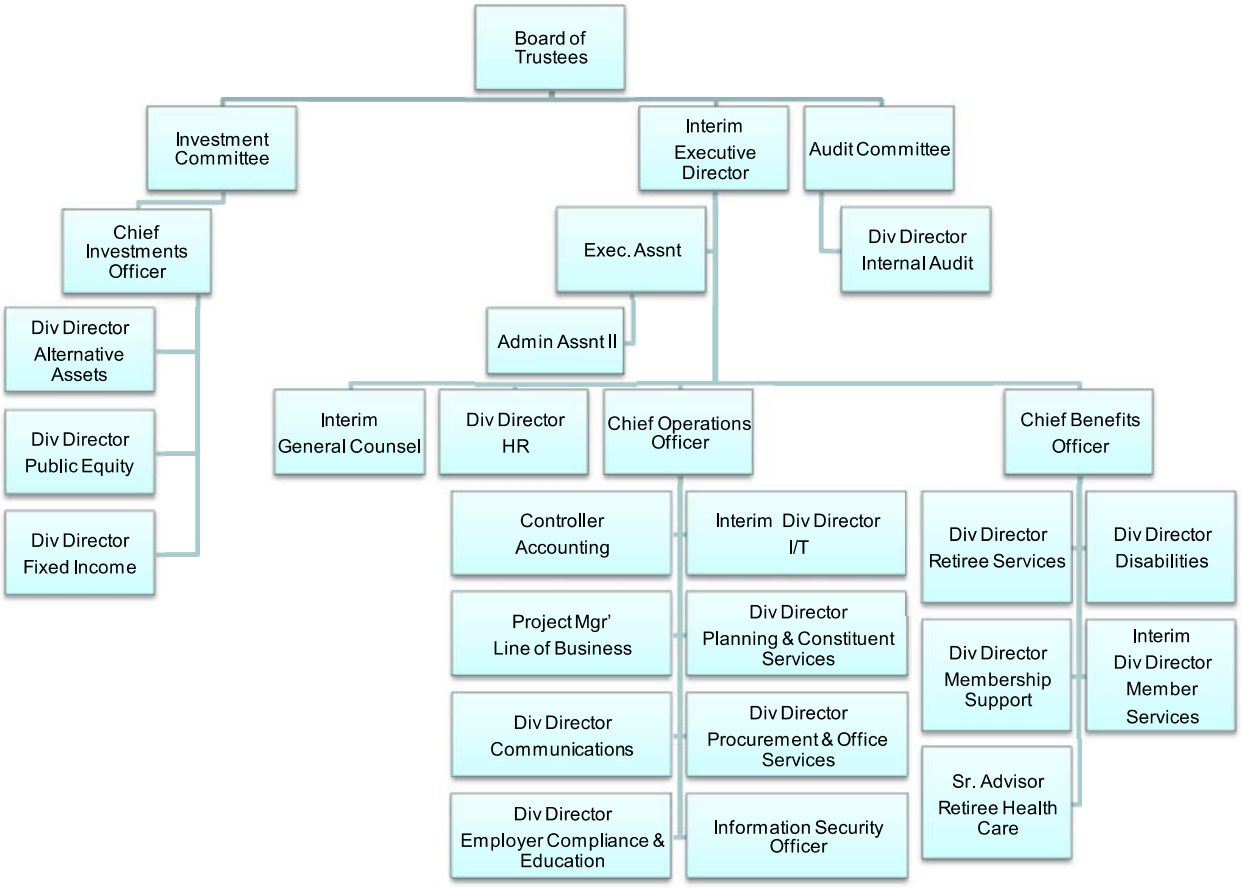
- Appoint all staff to all positions in the retirement systems, and manage the staff to perform all administrative functions of KRS;
- Develop a biennial budget and necessary budget amendments;
- Be responsible for information and record management, and develop and maintain a disaster recovery plan;
- Establish and implement policies in conformance with statutes, regulations and Board policies related to benefits administration;
- Provide oversight of litigation and report significant developments to the Board;
- Act as legislative liaison, and represent the Board at legislative hearings and other legislative meetings;
- Oversee the administrative appeals and disability appeals hearing process;
- Recommend legislative or regulatory changes and propose draft language;
- Provide technical assistance to the members of General Assembly, Governor's office, state and local government officials, members, retirees, and beneficiaries of the retirement systems;
- Communicate with the mass media and other agencies, entities or institutions, including responding to correspondence or inquiries addressed to the Board;
- Implement any statutory or regulatory changes and take appropriate action to conform with federal law; and,
- Coordinate reciprocal benefits with the other state administered retirement systems in Kentucky.

Reporting directly to the Executive Director are the General Counsel, Chief Operations Officer (COO), Human Resources Director, and Chief Benefits Officer. The areas that each of these individuals are responsible for are noted in the organizational chart. Both the Internal Auditor and the CIO do not report to the Executive Director, except for administrative purposes.

The Director of Internal Audit reports directly to the Audit Committee. The Internal Audit Charter describes the internal audit function as to "assist the Executive Director and management of KRS to attest to its governance role and achieve sound managerial control over all aspects of the operations of KRS including accounting, provision of benefits, asset management, information management, and control systems, and for such other activities for which they are responsible."

The CIO reports directly to the Investment Committee. This position provides general direction to the investment divisions' directors, serves as the primary advisor to the Investment Committee, and assists in developing policies and procedures to safeguard the systems' assets.

Kentucky Retirement Systems Organizational Chart



Source: Kentucky Retirement Systems

KRS Budget

The assets of the system are considered trust funds. The trust funds include investment earnings, employee contributions, and employer contributions from agencies that are supported by the General Fund, the Road Fund, Federal Funds, and Restricted Funds. All expenses incurred by KRS, including administrative expenses, are paid from these trust funds. Essentially, the General Assembly transfers the restricted funds budgeted for the operations of KRS in the *Budget of the Commonwealth* from the trust funds held by KRS solely for the benefit of members, retirees, and their beneficiaries. Even though the administrative expenses are included in the *Budget of the Commonwealth*, no General Fund dollars are appropriated to KRS.

The following table shows the amount requested by KRS and the amount appropriated by the General Assembly to cover administrative expenses in fiscal years 2007 through 2012. The amount appropriated is consistently less than the amount requested during this period.

Table 13: Restricted Funds Budgeted for Administrative Expenses at KRS

Fiscal Year	Amount Requested	Amount Enacted
2007	$23,901,900	$22,580,700
2008	25,206,100	24,253,100
2009	29,703,600	25,905,600
2010	31,335,600	26,725,500
2011	29,070,500	26,191,000
2012	29,867,400	26,191,000

Source: 2006-2008, 2008-2010, and 2010-2012 Budgets of the Commonwealth, Volume I – Operating Budget (pp. 52, 52, & 46, respectively).

Although not factored into the administrative budget approved by the General Assembly, expenditures for health insurance and third party claim expenses for health programs for those over and under the age of 65 are included in administrative expenses in the KRS' Comprehensive Annual Financial Report. Table 14 shows the actual administrative expenses, by category, for fiscal years 2006 through 2010. During this time period, an overall increase of $8,732,000 in expenditures occurred, which included a $6,141,000 increase in Healthcare Administrative Expenses.

Table 14: Administrative Expenses (Dollars in Thousands)

Expenses for the Fiscal Year Ended June 30th	2010	2009	2008	2007	2006
Personnel Services					
Salaries & Per Diem	$13,678	$13,323	$12,339	$11,429	$13,041
Fringe Benefits	4.407	3,964	3,445	3,230	2,964
Tuition Assistance	27	62	56	53	91
Total Personnel Services	**18,112**	**17,349**	**15,840**	**14,712**	**16,096**
Contractual Services					
Actuarial	251	263	474	470	161
Audit	58	49	49	42	23
Legal	308	231	843	395	522
Medical	273	298	222	255	288
Contractual	719	755	774	637	1,354
Total Contractual Services	**1,609**	**1,596**	**2,362**	**1,799**	**2,348**
Communication					
Printing	302	433	325	331	254
Telephone	143	170	138	147	172
Postage	577	655	634	633	637
Travel	163	166	205	236	218
Total Communication	**1,185**	**1,424**	**1,302**	**1,347**	**1,281**
Rentals					
Office Space	1,106	1,057	1,056	979	980
Equipment	91	97	86	67	57
Total Rentals	**1,197**	**1,154**	**1,142**	**1,046**	**1,037**
Miscellaneous					
Utilities	195	191	258	274	221
Supplies	156	220	230	268	165
Insurance	80	80	64	64	61
Maintenance	4	11	642	441	300
Other	1,447	1,418	569	687	361
Total Miscellaneous	**1,882**	**1,920**	**1,763**	**1,734**	**1,108**
Depreciation/Amortization	**863**	**525**	**498**	**439**	**387**
Total Pension Fund Administration	**24,848**	**23,968**	**22,907**	**21,077**	**22,257**
Healthcare Administrative Expenses	9,703	8,869	7,477	6,748	3,562
Total Administrative Expenses	**$34,551**	**$32,837**	**$30,384**	**$27,825**	**$25,819**

Source: 2006, 2008, and 2010 Comprehensive Annual Financial Reports for Kentucky Retirement Systems (pp.64, 92-93, & 83, respectively).

Chapter 2

APA Board Recommendation Review At KRS

As part of our examination of KRS, we performed a comparison of certain KRS policies, procedures and practices to the APA's "Recommendations for Public and Nonprofit Boards." This document, created by the APA as a result of recent investigations involving various public agency boards, was designed to assist both Public and Nonprofit Boards in providing appropriate financial oversight. While each recommendation is not applicable to every organization, each control area should be considered.

Through this comparison to the APA's 32 recommendations, we found KRS policies, procedures, and practices generally provide effective structure for the financial oversight of KRS. However, we make recommendations in Chapter 3, Findings and Recommendations, to further strengthen KRS controls and provide for greater Board oversight.

Below is a listing of the APA's 32 recommendations with any findings resulting from this comparison referenced to the findings and recommendations in Chapter 3:

1. The Board should have a well defined, clear mission statement to serve as a platform for policies, operational plans, and resource allocations that further the interest of its organization's members. **KRS appears to have adequately complied with this recommendation.**

2. The Board should facilitate the development of an annual orientation program and manual for new and returning Board members to ensure an understanding of the Board's structure, operations, and their legal and fiduciary responsibilities. An explanation of the budget and accounting structure, as well as revenue and investment information should also be included. If possible, the orientation should be facilitated by a knowledgeable, independent party, such as a Board attorney or consultant. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 10.**

3. The Board should ensure that its organizational structure maintains a flexibility that allows for multiple sources of information. The Board should request reports from individuals having responsibility for various program areas rather than from just the chief executive. **KRS appears to have adequately complied with this recommendation.**

4. The Board meeting minutes should document the exact nature of the financial reviews conducted by the Board. Any issues that result from these reviews and action taken to resolve the issues should also be documented. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 18.**

5. For Boards which fall under the open meetings law, sessions closed to the public should be entered into in accordance with KRS 61.810. Any conclusions or decisions reached during a session closed to the public must be documented in the Board meeting minutes as stated in KRS 61.815, clarified in Office of Attorney General (OAG) 91-387. **KRS appears to have adequately complied with this recommendation.**

6. The Board should establish an independent process to receive, analyze, investigate, and resolve concerns related to the organization including anonymous concerns. Employees, business associates, customers, or the general public may have significant, beneficial information that they are uncomfortable reporting directly to the Board. A toll-free complaint number or an advertised email and postal address for feedback would allow the transmission of this information. In addition, where applicable, the Board's policy should include a reference to Kentucky law (KRS 61.102) notifying employees, as defined in KRS 61.101, of their rights to protection against retaliation for reporting violations to certain authorities. A whistleblower policy should be adopted and distributed to employees. The policy should include reporting procedures and management's responsibility to address issues reported. **KRS had no established method for employees and citizens to anonymously report concerns. See Finding 15.**

7. An internal audit function could be used to ensure that Board concerns are independently investigated. The individual designated to perform internal audits should be given the authority to investigate and examine any area designated by the Board and the responsibility to report the audits findings directly to the Board. **KRS policy allows management to insert itself into the fraud investigation process. See Finding 9.**

8. A Board audit committee should appoint and compensate the audit firm and ensure the rotation of the lead audit partner and the audit partner reviewing the audit, as required by the Sarbanes Oxley Act (SOX) for companies with publicly traded stock. The Board should also consider whether rotating audit firms would be beneficial given the facts and circumstance of the organization. Further, if possible, the Board audit committee should be comprised of at least one member who has an understanding of generally accepted accounting principles and financial statements, experience with internal controls and in preparing or auditing financial statements, and an understanding of audit committee functions, as suggested in Section 407 of SOX. In addition, reviews of internal controls should be conducted to ensure that controls are functioning as designed or needed. The review of internal controls could be conducted by an internal auditor, Board designee, or included in the engagement of an auditing firm. Any concerns noted by the Board should be disclosed to the auditor and included in the audit scope for review. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 21.**

9. The Board should adopt a code of ethics that includes standards of conduct for its Board members, officers, and employees related to business conduct, integrity, and ethics. The policy should include the requirement to sign a form stating that they individuals have received and understand the code of ethics. The code should include statements regarding moral and ethical standards, confidentiality, conflicts of interest, nepotism, gifts, honoraria, and assistance with applicable audits and investigations. Violations of the code of ethics should be reported to the Board or designated committee of the Board. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 13**.

10. The Board should adopt a financial disclosure policy for Board members and executive management. A policy should also be developed requiring Board members and executive management to disclose any conflicts of interests. The disclosure form should be completed by a specified date and returned to the appropriate committee of the Board. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 12.**

11. The Board should establish and approve a detailed, equitable personnel and compensation policy. The policy should include that the Board or a designated Board committee annually review the salary increases and bonus payments made to all staff. This review should be documented in the Board meeting minutes. **KRS appears to have adequately complied with this recommendation.**

12. The Board should define and document all employee benefits in a fair and equitable manner. Benefits received that result in taxable income should be properly accounted for and accrued to each applicable employee. Employee benefits should also be reviewed to ensure they provide a reasonable business purpose. Also, membership fees to organizations or associations should provide a reasonable business benefit. **KRS appears to have adequately complied with this recommendation.**

13. The Board should approve the compensation package of the organization's primary executive and be aware of the compensation provided to other Executive Staff. In determining the compensation for the primary executive, the Board should consider the organizations financial resources, current economic conditions, employee performance, and salary data for similar positions at relevant organizations within the region. **The KRS Board is not made aware of the compensation provided to other executive staff. See Finding 16.**

14. The Board should ensure a well-defined employee evaluation system is implemented within the organization to consistently assess employee performance. The results of the employee's evaluation should be used for employee advancement or salary adjustments. **KRS appears to have adequately complied with this recommendation.**

15. The Board should adopt policies to ensure all forms of employee leave are properly approved and accurately recorded. **KRS appears to have adequately complied with this recommendation.**

16. The Board should have sick and vacation leave policies that address the accrual, use, and the payment to employees for any unused sick, vacation, or compensatory time. **KRS appears to have adequately complied with this recommendation.**

17. The Board policy should include a transparent, competitive selection process for the procurement of goods and services. The policy should outline the circumstances under which quotes or competitive bids are required and the process to be followed. The Board should have policies that require a formal contract for purchases over a specified amount and that all contracts over a specified dollar amount require Board approval. **KRS appears to have adequately complied with this recommendation.**

18. A review of budget to actual expenditures should be performed regularly by the Board or a designated Board Committee to monitor costs in each account. The name and number of budget categories or line items should provide transparency and sufficient detail to allow Board members to accurately identify the types of expenses being attributed to each category. If expenditures occur at an unexpected rate, additional detail should be requested to ensure that incurred expenditures are reasonable and necessary. **The KRS budget did not include investment related expenditures and did not designate a specific budget for its internal audit function. Further, KRS management did not routinely report budget-to-actual amounts to its board. See Findings 7, 16, and 17.**

19. At least quarterly, the Board or a designated Board committee should receive and review a listing of payments that includes, at a minimum, the payee, dollar amount, and date of each expenditure. This review would assist in identifying inappropriate, unusual, or excessive expenditures. **KRS did not report to its board investment related expenditures, including travel expenses incurred by KRS staff. See Finding 16.**

20. Executive management traveling out of state should present their plans and estimated costs to the Board for prior approval. The approval of these activities and associated costs should be addressed at the Board meetings to ensure proper documentation in the minutes. Subsequent to attending approved conferences or activities, the amount expended should be reported to the Board. **KRS did not consistently comply with its travel policies. Further, investment meetings and associated costs were not monitored by the Board to evaluate their necessity or cost effectiveness. See Findings 11 and 17.**

21. To minimize and control the cost of travel, a travel expense policy should be developed that specifically defines the allowable costs related to lodging, meals, entertainment, personal mileage reimbursement, rental cars, and airfare. The travel expense policy should state the invoice requirements for the reimbursement of certain expenditures such as taxi fees, tips, parking, or tolls. The policy should provide examples of expenditures that are to be paid for by the employee, such as costs incurred by family members or the attendance at events not approved by the Board. This policy should explicitly state that expenses not in compliance with the travel expense policy would not be reimbursed or paid by the Board. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 11.**

22. In lieu of credit cards, the Board should consider the following:
    - The use of purchasing cards that would allow the Board to restrict the types of purchases that can be made on the card based on industry codes. Casinos, specialty retail outlets, and food and beverage establishments are examples of these restrictions. The amount spent on a single purchase can also be restricted through the use of a purchasing card.
    - Reimburse employees personal credit card charges when the use is necessary. Procedures and supporting documentation requirements should be developed to facilitate this type of reimbursement.

    KRS appears to have adequately complied with this recommendation.

23. If the use of credit cards is needed, the Board should implement the following oversight controls:
    - A Board member or committee of the Board should be assigned to review, at a minimum, credit card statements of Executive Staff prior to payment.
    - Credit card charges should be supported by detailed receipts, documented business purposes, and supervisory approval. The employee should be responsible for the timely payment of any unsupported credit card charges or disallowed expenses.
    - Policies established by the Board should ensure that all review procedures are performed in a timely manner to avoid late fee and finance charges.

    KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 10.

24. Expenses classified as gifts or entertainment should be documented to include the name and title of the person(s) involved and a description of why the expense was needed and how it relates to business operations. **KRS appears to have adequately complied with this recommendation; however, further strengthening of the policy is recommended. See Finding 10.**

25. A policy related to reimbursements made by employees to the organization should be developed to ensure that any expenses that should be paid by an employee are monitored. This policy should include the timeframe allowed for making the reimbursement and the alternative actions that will be taken if reimbursement is not made. **KRS policies did not address the timing of when staff or trustees are required to reimburse the agency for any personal expenditure that may have been incurred. See Finding 10.**

26. Business expense reimbursements requested by executive management should be reviewed by the Board or a designated Board committee to ensure supporting documentation is provided. This documentation should be retained to ensure that duplicate payments are not made to the employee. **The KRS Division of Internal Audit reviews travel and expense reimbursements quarterly and reports the outcome to the Audit Committee. KRS appears to have adequately complied with this recommendation.**

27. Specific marketing goals should be developed to monitor the success of any business promotions approved by the Board. Marketing expenditures incurred should be coded to that goal so that Board members will know the expenses involved in a specific marketing promotion. Further, documentation should be maintained detailing the recipients of promotional prizes including tickets, trips, or merchandise. **KRS does not perform business promotions; therefore, this recommendation does not apply to KRS.**

28. A Board policy should be developed to address the authorization process to purchase vehicles and the method used to dispose of vehicles. The use and assignment of vehicles owned by the organization should be addressed within this policy. In addition, the practice of providing a vehicle should be reviewed and monthly vehicle allowances considered. The policy should include following the IRS guidelines for personal use of a vehicle. **KRS does not provide or assign vehicles to staff. KRS has one cargo van which it purchased new in 2001. Most KRS travel is reimbursed to the individual based on the mileage driven and the IRS approved rate.**

29. The personal use of business equipment should be addressed within Board policy to determine when appropriate. The policy should require that equipment being used inappropriately or that is missing should be reported directly to the Board. **KRS appears to have adequately complied with this recommendation.**

30. The Board should establish a policy detailing the process to report lost or missing financial information or records. To avoid lost or stolen financial information, electronic images of financial records should be created and retained, if possible. **KRS appears to have adequately complied with this recommendation.**

31. A formal policy should be developed that identifies what equipment is a fixed asset and should be included as inventory. Once this designation has been made, the existing inventory listing should include the following identifying information related to each piece of equipment:
    - The name of the individual in receipt of equipment;
    - Description of equipment;
    - Vendor name;
    - Model number;
    - Serial number:
    - Acquisition date; and,
    - Acquisition cost.

    Once the inventory listing has been validated, any acquisitions and dispositions of computer equipment that fall within the fixed asset policy should cause an appropriate update to the inventory listing. **KRS appears to have adequately complied with this recommendation.**

32. An information system policy should be developed that explicitly defines a user's responsibilities as they relate to information system resources and applications. These policies should cover, at a minimum:
    - Securing of user id and password;
    - Protection against computer virus or mal-ware infection;
    - Legal notice at logon indicating system is to be used for authorized purposes only;
    - Securing unattended workstations; and,
    - Securing portable devices, such as laptops, Blackberries, cell phones, etc.

    KRS appears to have adequately complied with this recommendation.

Introduction to Placement Agents at Kentucky Retirement Systems

Placement agents are intermediaries or third party marketers paid a fee by investment managers to solicit and secure potential investors. Over the past several years, investigations into illegal and unethical activity by placement agents were initiated within the New York State Common Retirement Fund (NYCRF), the California Public Employees Retirement System (CalPERS), and the New Mexico State Investment Council. In August 2010, a KRS internal audit draft report was presented that estimated almost $13 million had been paid to placement agents associated with KRS investments from July 1, 2004 through July 31, 2009. The internal audit also contained a finding that one particular placement agent had received fees from numerous investment managers for KRS investments made during the period reviewed by KRS internal audit.

The APA found that the use of placement agents was not transparent at KRS. One placement agent worked closely with the former CIO and was involved in numerous KRS investments without the knowledge of other KRS investment staff, KRS management, or the Board. Transparency is needed to ensure that investment decisions are made in the best interests of KRS and not the interests of placement agents or other parties. It was also determined that the payment of placement agent fees by investment managers did not correlate to an increase in the management fees paid by KRS or reduce the funds available to pay benefits to retirees.

Questions have been raised whether it is necessary for placement agents to be involved in KRS investments. SEC allows placement agents to operate in compliance with established SEC rules. Each public pension system must determine whether the involvement of placement agents is acceptable or should be prohibited. Certain investments may be unavailable to organizations that decide to ban investment managers that use placement agents. Therefore, the effect on KRS investment opportunities must be weighed against the risk of involving placement agents and whether this risk can be sufficiently mitigated through policy and monitoring.

Placement Agent Allegations in Other States

While the specific allegations in other states have varied regarding charges of unethical activity by placement agents, each involved placement agents attempting to influence the systems' fiduciaries to invest with the investment managers the agents represented. This is commonly referred to as "pay-to-play."

In New York, the State Comptroller is the sole trustee and manager of NYCRF. The New York Attorney General began investigating the investment practices of NYCRF in 2007. The former State Comptroller recently plead guilty to receiving nearly $900,000 in political contributions, travel expenses, and other benefits in exchange for investing with an investment manager represented by a placement agent that had political connections to the Comptroller.

In California, it was alleged that a placement agent, the CalPERS CEO, at least one board member, and possibly others conspired to ensure investments were made with the investment managers represented by the placement agent. In the fall of 2009, CalPERS commissioned a special review to be conducted by a law firm to review the fund's placement agent activity. A final report of the special review was released March 2011 and provides a detailed background of the circumstances and allegations against the involved individuals and made recommendations to address these issues. Criminal investigations of the allegations are still ongoing.

In October 2009, as part of a guilty plea to securities fraud, a former investment adviser to the New Mexico State Investment Council admitted that he recommended certain investments be made based on requests from certain politically-connected individuals. He did this knowing that the individuals would benefit either financially or politically from the investment deals. In May 2011, the New Mexico State Investment Council filed lawsuits in both federal and state courts related to "pay to play" schemes between 2003 and 2009.

Based on the information available to the APA, auditors found no evidence that a "pay-to-play" situation occurred at KRS. However, the APA's report will be referred to the SEC, which has the authority to determine if further investigation is warranted.

Structure of Alternative Asset Investments

The investment team of KRS is divided into three separate divisions: Alternative Assets, Equity Assets, and Fixed Income Assets. The investments classified within Alternative Assets involve nearly all of the contact between KRS and placement agents. This is largely due to the nature of the types of investments made under the alternative asset classification and the manner in which those investments are sought out and reviewed. Categories typically included within alternative asset investments include private equity, venture capital, hedge funds, private debt, leveraged buyouts, and energy partnerships. These types of investments account for approximately $1.6 billion or 11.3 percent of total KRS investments.

At KRS, alternative investments are typically structured as limited partnerships or limited liability corporations. Limited partners provide capital to an investment management firm to be invested according to a developed strategy. Limited partners have no management authority over the investment management firm, and are only liable for the debts of the firm up to the invested amount. The investment management firm's general partners use the capital provided by the limited partners to make investments according to an adopted strategy.

Management Fees

In addition to the capital invested by the limited partners, such as KRS, management fees are paid to the investment managers. These management fees are typically based on a percentage of the amount invested and are specifically documented in the contract with the investment manager.

The management fees paid by KRS on alternative asset investments are consistent within a narrow range of percentages, but can vary between individual investments. Even within similar categories, management fees may vary by one quarter to a half of a percent, depending on the investment management firm. While these variations appear small, the large amounts of funds being invested by KRS cause these small variations to equate to significant dollar amounts.

In calendar year 2009, KRS paid over $28,740,000 in management fees for investments in alternative asset classes. The full listing of management fees for each alternative asset investment can be found at Exhibit 4.

Use of Placement Agents

In order to obtain the capital required to develop an investment fund, general partners must seek out limited partners willing to invest. As a potential limited partner, KRS may be contacted by the investment manager through several methods. One method is for the KRS staff and/or its contracted investment consultant to contact investment managers that they have identified through contacts or research. Alternatively, the investment managers may use marketing staff to initiate contact with KRS staff or KRS consultants to discuss KRS investment needs. The marketing staff could be either an internal marketing group of the investment manager or a third party group under contract to act as a marketer for the investment product being offered. These third party marketers are known as placement agents.

An investment manager's decision to use a placement agent may stem from a variety of needs. Some small investment management firms do not maintain an internal marketing staff because it is not cost effective. Other firms may supplement their internal marketing staff by contracting out a portion of marketing services. Some investment managers may use an outside placement agent firm to benefit from the network of contacts it has developed. Under any of these or other possible scenarios, the investment manager typically retains the services of a placement agent prior to the investor being contacted by the placement agent on behalf of the investment manager.

Placement Agent Fees

Placement agents are paid by the investment managers based on a contractual agreement. Unlike management fees, the investor does not pay the placement agent fees. These fees may be based on a percentage of the total capital raised for the entire fund or it may be a percentage of the amount committed by each limited partner that the placement agent worked with to broker a deal. Depending on the terms of the contractual agreement, the investment manager may pay placement agent fees in a variety of ways, including payments over a number of years instead of an all inclusive one-time payment.

As seen in Table 15, the fees paid to the placement agents vary widely. This is due to the variance in the total amount of capital invested by KRS and the applicable fee agreed upon between the placement agent and the investment manager. Between July 1, 2004 and December 31, 2010, 12 placement agent firms were involved in 20 different KRS alternative investments representing 16 investment managers. For those investments involving two placement agent firms, it is typically assumed that the fees are split evenly between both firms, but specific details are not available.

Table 15 illustrates those investments and the fees estimated by KRS to have been paid to each placement agent by the investment managers, as of March 11, 2011. The table also includes the estimated future fees that investment managers may be obligated to pay the placement agents. The specific investment managers and placement agents are not identified by name in the table, but can be found at Exhibit 5.

Table 15: Placement Agent Fees Directly Associated with KRS Investments from 07/1/2004 through 12/31/2010

Investment Date	Investment Managers Using Placement Agents	Placement Agent Firm	Placement Agent Fees Paid *	Estimated Future Payments to Placement Agents *	Total Placement Agent Fees
01/31/2005	27	A	$169,114		$169,114
04/25/2005	28	A	$622,500		$622,500
12/15/2005	25	A	$260,000		$260,000
05/08/2007	27	A	$135,000		$135,000
10/10/2007	28	A	$150,938	$35,937	$186,876
07/25/2005	6	B	$1,250,000		$1,250,000
10/31/2005	40	B	$1,327,869		$1,327,869
11/07/2007	40	B	$262,500		$262,500
06/16/2008	6	B	$142,857	$857,143	$1,000,000
02/05/2008	36	C	$667,347	$82,653	$750,000
08/13/2008	10	C	$843,750	$281,250	$1,125,000
05/05/2009	7	C	$97,000	$682,500	$779,500
11/30/2004	20	D	$121,750		$121,750
03/31/2006	11	E	$600,000		$600,000
01/31/2008	26	F	$600,000		$600,000
06/16/2008	33	G;H	$218,988		$218,988
05/05/2009	9	I;J	$625,001		$625,001
04/14/2009	19	K	$291,667	$145,883	$437,550
09/29/2009	3	K	$175,000	$425,000	**$600,000
04/14/2009	34	K;L	$112,500	$400,000	$512,500
Totals			**$8,673,781**	**$2,910,366**	**$11,584,147**

Source: Auditor of Public Accounts based on information provided by the Kentucky Retirement Systems.
* These amounts were provided as of 03/11/2011 by KRS staff.
** The original agreement with the placement agent provided for a maximum fee of $1.2 million for the first $100 million invested by KRS and up to $2.4 million if KRS invested $200 million. At the request of the new KRS CIO, the investment manager amended the agreement to establish a new maximum placement agent fee for the $100 million already invested with no additional placement agent fee attached to any new funds invested by KRS. Based on the profit level of the first $100 million invested by KRS, the placement agent could receive an additional $300,000 for a maximum payment of $900,000.

Table 15 does not present the actual amounts received by the individuals working for the placement agent firms who had direct contact with KRS investment staff on behalf of the investment managers. Some firms involved in KRS investments, such as A and B, are large national and international organizations. Fees are distributed internally in accordance with their corporate structure. Other placement agent firms, such as placement agents C and J, may involve independent affiliates. Fee distribution in these organizations depends upon the agreements between the placement agent firm and the affiliates. Placement agent K is the only instance in which fees could be attributed to one individual.

Impact of Placement Agent Fees at KRS

As stated previously, KRS pays the management fees to the investment managers, but the placement agent fees are paid by the investment manager. The extent to which the placement agent fees impact the final management fee paid by the investor depends on the value the investment manager has associated with that service. Based on an evaluation of the management fees charged by investment managers to KRS, it appears placement agent fees have had no greater impact on the final cost to KRS than the fees charged by investment managers that use internal marketing staff.

Exhibit 4 includes the management fees for each alternative asset investment July 1, 2004 through December 31, 2010 with a notation for the involvement of a placement agent. As seen in the exhibit, management fees follow a pattern of similar percentages based on the classification of the investments and not the use of placement agents. There were two management fees within the "Buyout" category that fell outside of the normal percentage range. The highest outlier had no placement agent, while the lowest management fee paid did use a placement agent.

Similar instances were also seen in other investment categories, including "Venture Capital." The range of management fees for this category was 2.00 percent to 2.55 percent. Those investments with placement agents had management fees at both the low and the high end of that range, similar to those investments without placement agents.

Risk of Placement Agents

There is a risk that placement agents can cause undue influence that results in an investment that is not in the best interests of a public pension system. To address the risks involved with placement agents, various steps have been taken by the SEC, other state pension systems, and KRS. After the retirement system corruption cases in other states, the SEC instituted rules in 2010 effectively restricting placement agents from operating in a state for two years where they have made political contributions. New York has placed a permanent ban on all placement agent involvement with public pension investments. CalPERS now regulates the disclosure of placement agents, while also requiring that they register as lobbyists. In August 2009, KRS instituted placement agent disclosure policies to address the "pay-to-play" concern.

Finding 1: Former CIO violated KRS Placement Agent Statement of Disclosure Policy.

Related to a KRS investment approved at the September 29, 2009 Investment Committee meeting, the recommendation memo presented by the former CIO did not disclose that a placement agent was involved. The placement agent attended the Investment Committee meeting; however, the former CIO did not introduce him or inform the committee members of the placement agent's role in the investment. KRS approved a commitment to invest up to $200 million, in $50 million increments, without the knowledge that a placement agent was used and would be paid a fee by the investment manager. This is a direct violation of the Placement Agent Statement of Disclosure Policy that was adopted by the KRS Investment Committee on August 6, 2009, and ratified by the full Board on August 20, 2009. Specifically, the policy states:

> In the event a placement agent is expected to receive remuneration for a KRS investment, KRS Staff will notify the Investment Committee in the memorandum discussing the recommended/approved investment.

Not disclosing placement agent information in the recommendation memo also violates the stated purpose of the policy, which includes the following:

> The goal of this Policy is to bring transparency to placement agent activity in connection with KRS' investments and help ensure that KRS' decisions are made solely on the merits of the investment opportunity and in a manner consistent with the responsibilities of the Board of Trustees and individuals who owe a fiduciary duty to KRS.

While this policy did not specify which KRS staff are required to notify the Investment Committee, the former CIO was the primary KRS staff person involved in the review and recommendation of this specific investment, including writing the recommendation memo. As the head of the KRS investment staff, the CIO is ultimately responsible for reporting to the Investment Committee and implementing the investment policies. In addition, the former CIO assisted the former General Counsel in drafting the Placement Agent Statement of Disclosure Policy and would have been familiar with the policy requirement to disclose the placement agent in the investment recommendation memo.

Documentation shows that the former CIO knew that a placement agent was involved in this investment prior to presenting the recommendation memo to the Investment Committee. Emails document that the former CIO was in direct contact with the placement agent prior to and during the due diligence process for reviewing the investment manager. Further, emails also indicate that the former CIO was aware that a contract had been established between the investment manager and the placement agent.

Prior to the September Investment Committee meeting, the former CIO received the investment manager's contract on September 9, 2009. According to email documentation, the former CIO requested the contract from the investment manager to disclose the contract terms between the placement agent and the investment manager, as required by the Placement Agent Statement of Disclosure Policy. Due to citing this policy as the basis for requesting the contract, it is evident that the former CIO was aware of the policy requirements.

Conversely, the Investment Committee members did not inquire as to the involvement of a placement agent even though the members should have been aware of the policy that they had just approved. While the policy states it is the responsibility of KRS staff to ensure that Investment Committee members are informed of placement agents, the committee members also have a responsibility to be aware of this requirement and ask questions of KRS staff. However, the documentation of the September 29, 2009 Investment Committee meeting provides no indication that members asked about placement agents.

Considering the amount of the funds invested by KRS into a variety of investments, it is important that KRS Trustees have full knowledge of all aspects of the decision to determine which investments are appropriate. The use of placement agents adds another party into the investment transaction that already includes the fund manager, KRS, and the KRS contracted consultant. Having an additional entity, such as a placement agent, increases the potential risk of conflicts or undue influence if the agent is not involved in the investment process in a transparent manner.

The KRS Internal Audit Division's Placement Agent Audit draft, which was presented to the Audit Committee on August 17, 2010, concluded that placement agent information should be presented to the Investment Committee at the initial stages of the investment discussion. However, the internal audit draft did not report that the Placement Agent Statement of Disclosure Policy was violated by omitting the placement agent information in the recommendation memo. However, management's response to the internal audit acknowledged this requirement directly by stating:

> We concur that placement agents involved with investments in which KRS is considering should be disclosed within the investment recommendation memorandum as outlined in KRS' Placement Agent Statement of Disclosure, IV. Responsibilities, Section A.

The Placement Agent Statement of Disclosure Policy was approved by the Investment Committee one month prior to the investment recommendation being presented by the former CIO. The adoption of the Placement Agent Statement of Disclosure Policy should have clearly indicated that the KRS Investment Committee considers information about a placement agent to be important to investment decisions.

Recommendations

We recommend that KRS ensure that all information required by the Placement Agent Statement of Disclosure Policy is presented to the Board of Trustees or a designated committee in a clear and transparent manner.

We also recommend that KRS Trustees ensure full compliance with Placement Agent Statement of Disclosure Policy and inquire as to whether there is a placement agent involved in an investment decision.

We further recommend that the KRS Internal Audit Division ensure that the criteria used in their findings are based on the actual and complete policy requirement when comparing what should be happening to what is happening and report noncompliance with the policy.

Finding 2: Full disclosure of placement agent information was not obtained by KRS staff as required by the Placement Agent Statement of Disclosure Policy.

Significant disclosure of placement agent information is required by the Placement Agent Statement of Disclosure Policy (Disclosure Policy), adopted by the KRS Board in August 2009. This information was not obtained by KRS staff for an investment approved in September 2009. The Disclosure Policy requires that KRS staff are to obtain a written statement from the investment manager disclosing the use of a placement agent. If a placement agent was used by the investment manager, KRS staff are required to obtain ten specific items of information in writing from the investment manager prior to any investment being made. None of this information was obtained from the investment manager prior to the September 2009 investment being approved by the Investment Committee. After the approval of the investment, the final contract only included four of the required items.

According to the Disclosure Policy, if an investment manager discloses in the written statement that a placement agent was involved in a KRS investment opportunity, then the investment manager must also provide the following information:

- The name of the placement agent
- The fee paid or payable to the placement agent
- Representation that the fee is the sole obligation of the investment manager and not that of KRS or the limited partnership
- Current or former Kentucky Officials (federal state, and local government), KRS Board of Trustees members, KRS employees, or consultants to KRS that are receiving any fees or compensation from the External Manager and/or placement agent

- The names of any current or former Kentucky elected or appointed government officials (federal, state, and local government) KRS Board of Trustees members, employees, or consultants of KRS, or any other person, if any, who suggested the retention of the placement agent
- Evidence of the regulatory agencies, if any, in any Federal, state, or foreign jurisdiction the placement agent or any of its affiliates are registered with, such as the Securities and Exchange Commission ("SEC"), FINRA, or any similar regulatory agency
- A resume for each officer, partner or principal of the Placement Agent detailing the person's education, professional designations, regulatory licenses and investment and work experience
- A description of the services to be performed by the Placement Agent
- A statement whether the Placement Agent, or any of its affiliates, is registered as a lobbyist with any and all Kentucky state and local (county) governments
- A statement by the External Manager and/or placement agent representing and warranting the accuracy of the information provided to KRS regarding the Statement of Disclosure in any final written agreement with a continuing obligation to update any such information within 10 business days of any change in the information.

The KRS staff specifically responsible for obtaining this information from the investment manager is not clear, the policy only states that it is the duty of KRS staff. The Disclosure Policy does state that the written statement from the investment manager shall be "in a form acceptable to the KRS' Legal Office," indicating that KRS legal staff have some responsibility to establish a format for the information to be provided and to review the information to ensure it meets that required format. As the primary staff in contact with investment managers, it is reasonable that KRS investment staff are also included as intended responsible parties to obtain this information. As discussed in Finding 1, the former CIO was the primary investment staff responsible for the September 2009 investment.

The former General Counsel and the former CIO drafted the Disclosure Policy, which was then presented to the Investment Committee. Each of the three parties should have been aware of the requirements to obtain a written statement from the investment managers, as the policy was only adopted one month prior to the September 2009 investment. The failure to obtain full disclosure of all required placement agent information could likely have been avoided if the Disclosure Policy had given a specific party the responsibility for obtaining the statements from the investment managers.

In addition, the list of required items does not include political contributions. This information is necessary to ensure that the placement agents are complying with SEC rules that effectively prohibit placement agents' involvement in investments in states where political contributions had been made in the past two years.

Recommendations

We recommend that the KRS Board amend the Placement Agent Statement of Disclosure Policy to include a specific party responsible for obtaining the disclosure information from investment managers. This may be specific to the CIO or include other related KRS investment staff.

We also recommend that the KRS Legal Office work in conjunction with the KRS investment staff to develop a questionnaire to be distributed to potential investment managers to collect the required placement agent information.

We further recommend that the KRS Board revise the Placement Agent Statement of Disclosure Policy to ensure that all items disclosed by an investment manager are presented to the Investment Committee for review and consideration. Investment Committee members should be aware of all requirements in the investment policies to ensure they are enforced and used to guide the work of investment staff as committee members intended.

Finally, we recommend that the KRS Board amend the Placement Agent Statement of Disclosure Policy to require the investment manager include political contributions made by the placement agents to any Kentucky official within the prior two years.

Finding 3: Placement agent appears to have acted as a representative of KRS without disclosure to the Investment Committee.

The former KRS CIO worked in conjunction with one placement agent in a manner that lacked transparency and may not have been in the best interests of KRS. This working relationship appears to be different than that of other placement agents that had been in contact with the former CIO and resulted in the placement agent appearing to act as a representative of KRS rather than for the investment managers. This could conflict with the interests of KRS, as the placement agent may encourage an investment based on the placement agent fee received from the investment manager and not whether it was a good investment for KRS. Further concerning, it appears the former CIO did not fully disclose the extent of the placement agent's involvement to the Investment Committee, investment staff, investment consultants, and executive staff. This placement agent was involved in more investments during the former CIO's tenure than any of the other placement agents combined, indicating the possibility of preferential treatment.

Placement agents typically act as third party marketers hired by investment managers to seek out investors to act as partners in various types of investment funds. Investment managers retain the services of placement agents due to their own limited internal marketing staff or to receive the benefit of network contacts already established by placement agent firms. Agreements between the placement agents and the investment managers are typically solidified at the initial stages of developing the investment fund and before potential investors are contacted.

In contrast, this particular placement agent does not use retainer contracts with any investment managers making it unclear whose interests he represents at any one time. The placement agent screened a variety of investment managers and scheduled meetings between the former CIO and certain managers. Many of these meetings eventually led to investments by KRS.

According to email correspondence from September 2008, the placement agent scheduled meetings for the former KRS CIO with 12 different investment managers over a two day period in New York City. After the meetings, the placement agent sent a KRS investment consultant emails stating which investment managers the former CIO was interested in pursuing further. In December 2008, the placement agent set up another round of meetings in New York City for the former CIO to meet with nine different investment managers. The placement agent removed one of these managers from the schedule because as he stated "they got difficult." Meetings were also scheduled by the placement agent in San Francisco with three different investment managers in May 2008. In March 2009, a trip was scheduled for visits to Dallas and San Francisco with the placement agent suggesting a hotel for the former CIO in Dallas.

For the meetings referenced above, the placement agent's contact with KRS was not transparent and was limited to the former CIO, who was the only KRS investment staff member to attend these travel meetings with investment managers. In addition, because other KRS staff were not included in the email exchanges between the former CIO and the placement agent, there is no documentation that staff was aware of the placement agent's full involvement in the investment process.

KRS uses outside consultants to seek out and screen potential investment opportunities on behalf of KRS, which is an accepted common practice. These consultants are paid directly by KRS and are bound by contractual agreements to represent KRS. In contrast, this placement agent worked closely with the former CIO in seeking out investments for KRS and scheduling meetings, but without the knowledge or approval of the KRS Investment Committee. The placement agent was also paid by those investment managers with which KRS chose to invest. This may be in direct conflict with the best interests of KRS, as placement agents may be more inclined to bring KRS those managers that are willing to pay them the most advantageous fee.

During the former CIO's tenure, placement agents were confirmed to have been directly involved in 13 investment agreements. Of those, the placement agent working closely with the former CIO participated in seven of the investment agreements, which is more than all other placement agents combined. Due to the type of these investments, sufficient time has not yet passed to determine whether these investment decisions are beneficial to KRS.

Table 16 includes the fees paid by investment managers to the placement agent or other firms with which he was affiliated as of March 11, 2011. Only Placement Agent K identifies fees that can be directly attributed to the placement agent. It is not known how much of the fees were received directly by placement agents when acting as an affiliate of a firm. For those investments with two different placement agencies, it is typically assumed that the fees are evenly divided between the two firms.

Table 16: Fees for Investments Attributed to the Placement Agent as of March 11, 2011

Placement Agent ID	Investment Date	Fees Paid	Estimated Future Payments	Total Fees
K	04/14/2009	$291,667	$145,883	$437,550
K	09/29/2009	$175,000	$425,000	$600,000
K;L	04/14/2009	$112,500	$400,000	$512,500
C*	02/05/2008	$667,347	$82,653	$750,000
C*	08/13/2008	$843,750	$281,250	$1,125,000
C*	05/05/2009	$97,000	$682,500	$779,500
J*;I	05/05/2009	$625,001	-	$625,001

Source: Auditor of Public Accounts based on information provided by the Kentucky Retirement Systems.
* Fees were paid to a placement agent firm. The actual fees paid to the placement agent as an affiliate are not known.

There is no evidence that the KRS executive staff were aware of the role played by the placement agent. The Executive Director has administrative authority over the CIO and approved the former CIO's travel request and expense documents. However, as noted in Finding 11, that information was inconsistent and would not disclose the involvement of the placement agent. According to the former Executive Director, he had only been introduced to the placement agent by the former CIO at an Investment Committee meeting, but the placement agent's role was never stated.

Considering that the former General Counsel worked with the former CIO to develop the contractual agreements between KRS and the investment managers, the General Counsel could have been informed of the placement agent's involvement. However, identifying the placement agent used in making an investment did not have to be documented in the investment contracts until the August 2009 approval of the Placement Agent Statement of Disclosure Policy. Neither the former General Counsel nor the former Executive Director would have known the full extent of the former CIO's activities during due diligence trips coordinated by the placement agent without the CIO revealing these details.

Similar circumstances also surrounded the investment consultants under contract with KRS and this placement agent. According to one KRS consultant, placement agents are normally identified during the due diligence review process for an investment. With this placement agent, the consultants were typically unaware of the placement agent's involvement during the initial stages of an investment review, and in some cases not until the end of the process.

Even once the Placement Agent Statement of Disclosure policy was approved in August 2009, the former CIO failed to disclose the involvement of the placement agent. While the placement agent attended Investment Committee meetings, his role or involvement was not discussed with the committee members.

Because the Investment Committee makes the final decision on all KRS investments, it could be argued that the preferences of the CIO alone could not completely influence the final outcome of the investment process. However, Investment Committee members rely on the information brought to them in the recommendation memos prepared by KRS investment staff. The CIO would review and approve the final recommendation memos. This is a powerful position given that, according to investment staff, the Investment Committee members have never failed to approve an investment recommendation brought to them.

It is unknown why the former CIO chose to operate so closely with an outside placement agent without including other staff or informing the Investment Committee. The KRS Internal Audit's Placement Agent Audit noted that the individuals had a prior working relationship when the former CIO worked with the Pennsylvania State Employees Retirement System. However, the information does not suggest that the prior relationship was more than minimal business interaction. In addition, based on the information available to the APA, there is also no indication that the former CIO received any tangible benefit from the relationship with the placement agent.

In a brief discussion with the former CIO, he stated that the use of the placement agent was a benefit to KRS because the placement agent was bringing investments to KRS at his own cost and at no risk to KRS. However, the manner in which the placement agent was being paid lacked transparency and increased the risk of a conflict of interest. The risks associated with that conflict may negate any of the benefit that could have been realized. If the former CIO considered the placement agent a benefit to KRS without any risks, it is unclear why this service was not discussed with other KRS investment staff, executive staff, or the Investment Committee.

Under the management of the current CIO at KRS, investment policies have been developed and adopted by the Investment Committee. In February 2011, an addendum to the Transaction Policy for Limited Partnerships was approved and requires greater accountability and transparency of staff by specifying the information that should be documented and presented to the Investment Committee. Combined with the Placement Agent Statement of Disclosure Policy, the new policies should aid in providing the Investment Committee with sufficient information to detect unusual practices that may not be in the best interests of KRS.

Besides adopting additional policies, it is also imperative that Investment Committee members become familiar with the adopted policies and ask probing questions of staff, consultants, and potential investment managers. For example, no one on either the Investment Committee or the full KRS Board inquired about the involvement of placement agents at KRS when the Placement Agent Statement of Disclosure Policy was being proposed and approved in August 2009. Further, only one month after approving the Placement Agent Statement of Disclosure Policy, the Investment Committee approved an investment without asking the former CIO if a placement agent was involved. In fact, the investment did involve the placement agent that had been working closely with the former CIO.

To further enhance transparency the California legislature passed legislation effective January 1, 2011, to require placement agents to be registered as lobbyists. This action was taken in response to allegations of undue influence and involvement of placement agents in CalPERS investments.

Recommendations

We recommend that KRS Investment Committee members ensure that all adopted investment policies are carried out by staff as intended. This can be accomplished by requiring reports and disclosures concerning the activities of investment staff and KRS contractors as discussed in Findings 2 and 4. Investment Committee members should ensure they are familiar with the adopted policies so that they are able to ask the mandatory questions related to these policies.

We also recommend that the KRS Investment Committee and Board strengthen the Placement Agent Statement of Disclosure Policy by establishing guidelines for how the information provided is evaluated. This includes what action to take if a conflict is revealed between the placement agent and KRS staff members or officials.

Finally, we recommend to further enhance transparency the General Assembly consider requiring the registration of placement agents as executive agency lobbyists with the Executive Branch Ethics Commission. This action may require expanding the definition of "Executive agency" in KRS 11A.201(6) to include Kentucky Retirement Systems.

Finding 4: A standardized investment recommendation process did not exist under the former CIO.

Prior to adopting additional investment policies in February 2011, KRS investment policies did not include specific guidelines for the type of information that must be presented to Investment Committee members when KRS investment staff submits recommendations for investments. The lack of standardization allowed the former CIO to determine what information would be provided to committee members as part of their review and approval process. This resulted in the Investment Committee not being informed of placement agents, KRS contracted investment consultants not providing recommendations for certain investments, and investment staff concerns not being considered.

According to the Pension Fund Statement of Investment Policy, the Investment Committee is responsible for the selection of investment managers. The Investment Transaction Procedures Policy further outlines that the selection of Alternative Asset investment managers is to be based on the work performed by investment staff. This work includes interactions with investment managers, conducting due diligence reviews of investment opportunities, and providing recommendations to the Investment Committee. During the tenure of the former CIO, the investment policies did not specify the amount of detail regarding the work investment staff should include in a presentation to the Investment Committee. It was at the discretion of the staff to determine whether to include information such as risks associated with the investment, investment managers considered, and the specific steps taken to identify potential managers.

Prior to August 20, 2009, 12 different placement agents were involved in nineteen KRS investments. The placement agents had direct contact with KRS staff while marketing investment opportunities, but the Investment Committee was not informed. This is because the requirement to notify the Investment Committee of placement agent involvement in KRS investments was not in place until the approval of the Placement Agent Statement of Disclosure Policy on August 6, 2009. Instead, the former CIO was given full discretion over interactions with any party associated with investments with no requirement for disclosure to the Investment Committee.

Investment policies also did not require the KRS contracted investment consultants to be included in the investment process. On four occasions between 2007 and 2009, investments were brought to the Investment Committee without the involvement of the consultant for alternative assets. Three of these investments did not involve placement agents. For these investments, the secondary review and recommendation provided by the outside consultant was not available. While there was no requirement that the consultant be involved, it is unusual that the consultant was not used considering that KRS paid the consultant $276,500 in FY 2008 and $288,250 in FY 2009 to perform this type of service. Based on information provided by the consultant, the omission of a review and recommendation by the contract consultant only occurred during the tenure of the former CIO.

No policies at KRS established a method for investment staff to relay concerns about investments directly to the Investment Committee. Based on interviews with KRS staff, certain investment staff had concerns about the manner in which an investment opportunity had been reviewed and presented to the Investment Committee by the former CIO in September 2009. See Finding 1. The former KRS Executive Director was informed of these concerns, and stated that he provided the information to the former Investment Committee Chair. The former Investment Committee Chair did not recall any concerns being expressed regarding this investment and no documentation was provided that the information was given to the Investment Committee Chair.

As the supervisory body for the investment function at KRS, it is the responsibility of the Investment Committee to ensure that the work conducted by investment staff is in accordance with committee members' expectations and needs. According to the Pension Fund Statement of Investment Policy,

> The Chief Investment Officer is responsible for administration of investment assets of the Systems consistent with the policies, guidelines and limits established by the law, this Statement of Investment Policy and the Investment Committee.

While the authority for administering the investments of KRS is given to the CIO, the Investment Committee must develop the policies and guidelines under which the CIO is to operate.

In February 2011, the Investment Committee did approve an addendum to the Transaction Policy for Limited Partnership Investments. This new policy addendum outlines the research process required to be conducted when KRS investment staff are performing a due diligence review on a prospective investment. It also outlines the information that is required to be presented to the Investment Committee once investment staff decide to recommend an investment opportunity, including any involvement by placement agents. The new policy also states that a retained investment consultant shall perform a due diligence review of any investment that is to come to the Investment Committee for approval, though a recommendation is not required.

Given the adoption of this new policy, many of the overall concerns with the investment process have been addressed; however, the newest policies can be strengthened and clarified to ensure full disclosure is made to the Investment Committee.

Strengthening KRS investment policies to require additional documentation resulting in further transparency assists in ensuring a consistent process that provides a detailed account of how investment decisions are made. On May 25, 2011, it was reported in the media that, at least twice in recent years, the Governor's Office contacted the former KRS Executive Director to suggest that KRS meet with individuals working on behalf of two investment firms. APA auditors investigated this issue to determine if these contacts were made in an attempt to influence the investment decisions of KRS. Auditors requested and reviewed information from KRS and contacted current and former KRS Board Trustees, employees, and others regarding this issue.

Based on the information reviewed and the statements made by those contacted, auditors concluded that no outside pressure influenced KRS investment decisions. KRS appears to have held the meetings with the firms as a courtesy to explain the process followed to select investments and for the firms to share information regarding their investment products. The former Executive Director stated that he felt no pressure to do business with the firms and other investment staff interviewed stated the meetings had no impact on the procurement process. According to interviews, the former KRS Executive Director attended a meeting with one firm, while he and the former CIO met with another firm; however, KRS did not place investments with either firm. Though no undue influence was found resulting from these meetings, the following recommendations ensure more transparency for all future investment decisions.

Recommendations

We recommend that KRS investment staff and Investment Committee members ensure consistent compliance with all established investment policies. In addition to the information currently required to be presented to the Investment Committee under the addendum to the Transaction Policy for Limited Partnerships, investment staff should include the following information:

- The specific KRS investment policy and strategy associated with the investment and how that investment meets the requirements;
- Which firms were considered as the primary options;
- What steps were undertaken to locate the firms considered and all individuals or firms involved in identifying investment options and their services;
- Any risks associated with the recommended investment and the mitigating factors that allowed the investment to be recommended; and,
- A recommendation from at least one investment consultant on contract with KRS or explanation of why no consultant recommendation could be given.

We also recommend that KRS establish a formal method for investment staff to convey concerns about a potential investment to Investment Committee members when their concerns are not addressed by the recommendation memo. This method should alleviate the concern of reprisal. Investment staff should also be informed to bring concerns to the KRS Division of Internal Audit if possible fraud is suspected.

Chapter 3
Findings and Recommendations

Introduction to Internal Audit Findings

The KRS Division of Internal Audit was established in 2007 with the task of providing an "independent appraisal of the various operations and systems of control within Kentucky Retirement Systems." The Audit Committee of the KRS Board oversees the actions of this division. An annual audit plan is developed and submitted to the Audit Committee that includes regular audits of the administrative functions within KRS. According to the Division of Internal Audit Charter, auditors may also undertake other types of special audits at the request of the Audit Committee or KRS management.

In October 2009, the former KRS Executive Director met with the Director of Internal Audit to request an internal audit related to the involvement of placement agents within the KRS investment process. According to a memorandum from the Division of Internal Audit to the KRS Board dated January 15, 2010, the goal of the internal audit was to "look back at the relationships we have had with placement agents in order to have a better understanding of the role placement agents' play, the level of their involvement in KRS and the degree they were involved within our asset classes."

A final report draft with the response from KRS management was submitted to the Audit Committee on August 17, 2010. The draft report contained six findings and provided seven recommendations to KRS. The draft report also included an appendix that listed the placement agents involved in KRS investments over a five year period and their fees paid by investment managers. See Exhibit 1 for a copy of this draft report, including the KRS management response. However, many of the placement agent fees included in the draft report have since been updated by KRS staff.

Upon submission of the draft audit report, the Audit Committee approved the document and sent it to the full KRS Board for further approval. The Board did not approve the draft report and sent the audit back to the Audit Committee due to concerns regarding the internal audit process and the resulting draft report. The concerns expressed at the full KRS Board meeting and the subsequent Audit Committee meeting included the following:

- The audit process was conducted without full disclosure to the Board and the Audit Committee;
- The audit process may have been influenced by outside sources;
- Information found during the audit was withheld from some trustees;
- The release of the audit may have been purposefully delayed; and,
- The internal audit did not fully explore certain issues.

To address these concerns, the APA responded to requests to review certain issues at KRS and initiated an examination. During our examination, we interviewed the KRS internal auditors, reviewed the internal audit documentation, and conducted interviews with current and past KRS Board trustees, executive management, an extensive list of other KRS staff, and outside sources. We also reviewed internal audit email correspondence concerning the placement agent audit and conducted further research related to placement agents. The APA review found no evidence to demonstrate that information from the internal audit was withheld, delayed, or otherwise covered up with the purpose of hiding fraud or other wrongdoing.

The APA findings related to KRS internal audit involve the procedures used to monitor the internal audit function and ensure that this process maintains its independence from KRS management. Specifically, the Audit Committee had not established any specific procedures for conducting a special audit, which resulted in the internal auditors having flexibility in the process. This flexibility resulted in the involvement of executive staff in some audit procedures, which gave the executive staff greater access to preliminary audit information than the members of the Audit Committee. While there is no evidence that executive staff involvement hindered the audit procedures or conclusions, their involvement negatively affects the perception of independence that should be maintained by the internal auditors. The accompanying recommendations are designed to ensure that the Audit Committee adequately monitors the KRS internal audit function so that its independence from KRS management can be maintained.

Exhibit 3 provides a timeline of events and correspondence affecting the internal audit of placement agents. This timeline identifies when the internal auditors received any preliminary information, what information was provided to the KRS Board, and when audit work was completed. It also contains the instances in which the executive staff members were involved in the audit process and when the internal auditors provided information to KRS Board trustees.

Finding 5: Procedures for conducting a special audit that would document the requirements of the Division of Internal Audit or the Audit Committee did not exist.

The current Division of Internal Audit Procedures Manual (Procedures Manual) dictates that the Audit Committee must annually approve the schedule of audits contained in the Annual Audit Plan in May, but it does not contain any procedures on how special audits should be initiated, approved, or conducted. Specifically, the Procedures Manual does not require that the Division of Internal Audit request preapproval or guidance from the KRS Audit Committee on special audits not included in the Annual Audit Plan. The Director of Internal Audit did not inquire as to what procedures to follow in the absence of a documented process, but relied on professional judgment when the former KRS Executive Director requested a review on the use of placement agents. The lack of procedures limited the involvement of the Audit Committee and caused confusion regarding the audit process among Audit Committee members and the Division of the Internal Audit.

The Procedures Manual defines a variety of special audits that may be carried out by the Division of Internal Audit. These include information technology audits, investigative audits, management audits, and performance audits. While there is a definition as to why these audits would be performed and their purpose, there are no procedures associated with the actual conduct of these audits. There are no procedures that discuss the level of Audit Committee involvement in the approval process or the development of audit scope.

According to the KRS Audit Committee's Charter, the Audit Committee has the responsibility "to institute and oversee special investigations." However, this responsibility is not reflected in the Procedures Manual so there were no procedures that required the Audit Committee to approve the Placement Agent Audit prior to its initiation.

In the absence of an established policy or procedure to convey the expectations of the Audit Committee concerning special audits, the Division of Internal Audit developed a process for the Placement Agent Audit based solely on judgment. Regarding the communication of audit results, the internal auditors followed the standard process required for audits already approved within the Annual Audit Plan. However, additional steps were taken to notify the Audit Committee of actions taken and the preliminary data received. In addition, the former Chair of the Audit Committee was also provided with a summary of findings prior to the report draft.

The Placement Agent Audit was initiated by a request from the former Executive Director to the Director of Internal Audit at the end of October 2009. This request was not presented to the Audit Committee at their next regularly scheduled meeting on November 5, 2009, but there may not have been sufficient time to perform preliminary research for a presentation to the Audit Committee. By November 24, 2009, the scope and audit plan had been developed but the Audit Committee was not informed of the Placement Agent Audit until the next scheduled quarterly meeting on February 4, 2010.

The initial presentation of the Placement Agent Audit included a memorandum that disclosed the general scope of the audit and the work conducted up to that time. A spreadsheet was attached to the memorandum titled, Placement Agent Used During Engagement, that listed the names of placement agents that were associated with KRS investment managers. This information did not include the fees paid to the placement agents by the investment managers because not all of the information was available until February 26, 2010. During this initial presentation, the Director of Internal Audit did not request approval or further guidance for the audit, but the Audit Committee members asked few questions and provided no feedback.

When the placement agent information being collected was complete, the internal auditors noted that one placement agent appeared more than any other during the tenure of the former CIO. Based on the potential risk of any preferential treatment, additional audit steps were developed. This included interviews with pertinent KRS staff, KRS investment consultants, and the placement agent in question. During this process, the former KRS Executive Director and former General Counsel participated in some interviews and research. While this is not a violation of policy or procedure, the impact this had upon the independence of the internal audit function is discussed further in Finding 6.

On April 27, 2010, the additional audit work was completed and the Division of Internal Audit began formulating findings. After the May 4, 2010 Investment Committee meeting was adjourned, the former Chairs of the Investment and Audit Committees were privately informed of the audit findings. At the May 13, 2010 meeting of the Audit Committee, members were notified that work on the audit was still ongoing, but no specific findings or preliminary information was presented. While additional audit procedures could have been taken, such as requesting email information related to the former CIO, this was not discussed with the Audit Committee; however, committee members did not ask questions concerning the extent of the progress of the audit or the potential findings.

Per the Procedures Manual, the standard audit process is to draft the report and receive management's response prior to providing the report draft to the Audit Committee. After receiving management's response to the final draft of the audit on July 12, 2010, the report was sent to the Audit Committee as well as the Investment Committee. The Investment Committee received the draft because the Division of Internal Audit was requesting a management comment related to the committee's oversight of KRS investments. Due to scheduling, the Investment Committee meeting was held before the Audit Committee's meeting, which gave the Investment Committee members an opportunity to discuss the report before it was discussed with the Audit Committee.

At the August 17, 2010 Audit Committee meeting, the report draft was presented for discussion and approval. At this meeting, Audit Committee members raised a number of concerns about the process in which information from the audit was disseminated to trustees. While internal auditors could have taken certain steps to more fully discuss the audit with the Audit Committee during the audit process, by not establishing more specific procedures, it was the Audit Committee that allowed the Division of Internal Audit the flexibility to develop the audit scope and determine what process to follow.

The manner in which the audit process was performed was not a violation of the Division of Internal Audit Charter or the Procedures Manual. However, had the internal audit procedures required the Director of Internal Audit to bring information regarding potential conflicts of interest or unethical practices directly to the Audit Committee, the actions of the former CIO and a placement agent that should have been disclosed may have been more fully examined. These actions are identified in Findings 1 through 3 of our audit report. This could have resulted in changes to the investment policy and potential personnel actions in connection with the former CIO, who resigned on June 24, 2010, which was prior to the presentation of the final report draft.

Recommendations

We recommend that the KRS Audit Committee develop and approve procedures that document the requirements related to special audits requested by management or external sources. Because the Audit Committee is only required to meet on a quarterly basis, procedures must be developed to guide the day-to-day activities of the Division of Internal Audit. The adopted procedures should state the Audit Committee's process to request and approve special audits, whether preliminary research should be conducted prior to approval, the amount of the Audit Committee's involvement in the audit scope and methodology, the type and method of communicating information to the Audit Committee prior to the completion of the audit, the distribution of the draft audit report, and when a special meeting should be conducted to discuss a special audit.

We recommend that the Fraud Management Policy be integrated into the Internal Audit Procedures Manual. See Finding 9 for further discussion.

Finding 6: The involvement of executive staff in the internal audit process diminished the perception of independence within the internal audit function.

The KRS Internal Auditors included the former Executive Director and former General Counsel in the performance of the Placement Agent Audit, potentially compromising the integrity of the audit and creating a perception of a lack of independence in the internal audit function. Internal auditors requested that the former General Counsel attend three interviews conducted as part of the internal audit process and allowed the former Executive Director to also attend. The former General Counsel also conducted research on a particular placement agent on behalf of the internal auditors. Further, the former Executive Director and former General Counsel were consistently updated on the potential concerns revealed during the fieldwork phase of the Placement Agent Audit, while the Audit Committee was not informed of the specific findings until the final draft report was released. While there is no evidence to demonstrate that either the former General Counsel or the former Executive Director unduly influenced the internal auditors or the audit process, their direct involvement diminished the perception of independence and thus the integrity of the final audit product.

During the Placement Agent Audit conducted by the KRS Internal Audit, additional audit work was performed when it was found that one placement agent had been involved in more investments than any other placement agent during the tenure of the former CIO. The internal auditors determined that interviews were needed with the former CIO, the KRS Director of Alternative Investments, the identified placement agent, and two investment consultants retained by KRS on contract. While the former CIO and the Director of Alternative Investments were interviewed by an internal audit staff member only, the other three interviews included the former General Counsel and the former Executive Director. According to the Director of Internal Audit, executive staff were included to emphasize the importance of the interviews to KRS.

Based on a previous position with another agency, the Director of Internal Audit had the perception that internal audit working papers were subject to an open records request under KRS 61.872. It was then rationalized by the Director of Internal Audit that including the former General Counsel in the audit process would protect certain documents from open records requests due to attorney-client privilege. However, the Director's concern for protecting audit working papers is not necessary due to exemptions under KRS 61.878(1)(i) and (j), which has been interpreted by the Kentucky Attorney General in several opinions to apply to audit working papers.

According to both internal auditors that conducted the Placement Agent Audit, neither the former Executive Director nor the former General Counsel hindered their ability to ask questions during the three interviews. It was also conveyed by the internal auditors that the former Executive Director did not ask questions during the interview and was primarily there to listen. Based on a comparison of the questions prepared by the internal auditors prior to the interviews with the notes from the meetings, it does appear all of the planned questions were asked. However, the extent to which the presence of the executive staff affected the responses of those interviewed or the internal auditors' additional follow-up questions cannot be known.

The internal auditors also requested the former General Counsel conduct research on the placement agent in question to determine if there were any connections to potential "pay-to-play" arrangements. According to internal auditors, this was due to the former General Counsel having the only access to certain legal databases. However, the internal auditors should have worked in conjunction with him to direct his actions or requested access to the information to perform the work themselves. There was no written request from the internal auditors stating the scope of the research, nor was there a summary of the work completed. The audit documentation does include the results of searches conducted, but the former General Counsel stated that minimal documentation of these searches was available because most resulted in no returns. To confirm the conclusions of the former General Counsel, this work was re-performed by the APA.

While the internal auditors should have access to assistance from legal counsel, the General Counsel could not be considered independent from the investment process. The General Counsel develops the investment contracts between KRS and investment managers that pay the placement agents. In working with the former CIO to develop these agreements, the former General Counsel played an integral role in documenting and disclosing the final terms in the investment process.

In addition to assisting in the audit work process, the former Executive Director and former General Counsel were included in discussions with the internal auditors about potential findings throughout the Placement Agent Audit. Based on email correspondence, both executive staff members were notified of findings and concerns prior to the Audit Committee being notified. An April 30, 2010 email from the Director of Internal Audit to both the former Executive Director and the former General Counsel indicates that the internal auditor met with these executive staff to discuss the potential findings of the Placement Agent Audit. No records of this meeting are available. While preliminary findings were later reported to the former Chairs of the Audit Committee and Investment Committee on May 4, 2010, the full Audit Committee was not informed of the information known by the executive staff. Another email on June 8, 2010 from the in-charge internal auditor to the former General Counsel states that the draft report is completed and requests a meeting to discuss. As discussed in Finding 5, the Division of Internal Audit followed the standard audit process in which Audit Committee members are not informed of preliminary findings until a final report draft is completed.

Internal Audit did not indicate that including the former Executive Director and former General Counsel hindered or controlled the audit process in any way. However, the involvement of KRS executive staff caused mistrust among the Audit Committee members that rely on the Division of Internal Audit to review management activities.

Recommendations

We recommend that the KRS Division of Internal Audit conduct all audit fieldwork in an independent manner separate from the influence of KRS management. Managements' role is to provide the requested documents but it does not include performing audit procedures or evaluating documents, audit findings, or audit conclusions.

We also recommend that the Director of Internal Audit retain outside counsel if there is any perceived conflict in the use of the KRS General Counsel for legal assistance, as allowed for under the Audit Committee Charter. Outside counsel also includes the assistance of the Attorney General's Office as allowed for under KRS 61.645(11).

We recommend that the Division of Internal Audit operate with the understanding that audit working papers are not subject to the open records law, KRS 61.872, as allowed for in KRS 61.878(1)(i) and (j) and as stated in various Kentucky Attorney General opinions. However, it should be clearly understood that a document already subject to open records that is placed in audit working papers retains its identity as an open record.

Finding 7: KRS does not have a specific budget for the Division of Internal Audit.

The KRS budget does not include a separate line item for the Division of Internal Audit. The lack of a specific budget for internal audit potentially limits the Audit Committee's oversight of the internal audit function and the independence of the internal audit function. The budget for the internal audit function is instead developed by the COO based on discussions with the Director of Internal Audit and then submitted to the Board of Trustees for approval as part of the overall KRS budget. There is no documentation of the amount of funds allocated to the Division of Internal Audit because the KRS budget is compiled by expense category and not by office grouping. In the event that the Director of Internal Audit assesses a need to expend funds beyond staff and regular supplies, a request must be submitted to the COO. It is then at the discretion of the COO to determine availability of funds under the budget. This reduces the independence of the internal audit function because the executive staff can control Internal Audit's funding.

Under the current budget process, the Audit Committee of the Board of Trustees is not involved in planning or developing a budget proposal specifically for the Division of Internal Audit. Budgetary discussions only occur at meetings of the full Board of Trustees for review and approval. While all members of the Board of Trustees have the opportunity to review the proposed overall budget for KRS, this budget does not specify the exact funding for the Division of Internal Audit.

Without a documented budget allowance based on anticipated workloads and other needs, it is possible for the COO to arbitrarily deny an expenditure request made by the Division of Internal Audit. While a funding request could be denied due to valid budgetary constraints, this ability allows the COO to impact the internal audit function through funding. Without a distinct budget process for the internal audit function that involves the Audit Committee, the COO is in the position to approve or deny additional funding for internal audit.

According to the Division of Internal Audit Charter,

> Internal Auditing is an advisory function having independent status within Kentucky Retirement Systems. The Internal Auditor – shall be functionally responsible to the Audit Committee and administratively responsible to the Executive Director and be independent of any other section, branch or officer…

This statement establishes the independence of the internal audit function, as well as the Audit Committee's responsibility to determine how the Director of Internal Audit functions. In addition, this statement also makes the Executive Director responsible for overseeing the day-to-day administrative tasks of the internal audit function. This responsibility is typically given to management to ensure the individual is complying with other operating policies such as the approval of timesheets and leave requests. These are actions that the Audit Committee members could not oversee at the regular quarterly meetings; however, the oversight of a specific budget for the Division of Internal Audit can be accomplished at quarterly meetings.

As the body established for overseeing the internal audit function on behalf of the Board of Trustees, the Audit Committee's charter includes a responsibility to "ensure there are no unjustified restrictions or limitations" on Internal Audit. The current budget process restricts the independence of the Division of Internal Audit and diminishes the oversight role of the Audit Committee. There is a potential for restrictions or limitations if KRS executive staff control the funding levels of the Division of Internal Audit. Because the Division of Internal Audit is responsible for evaluating KRS operations, their funding decisions should not be made by staff that are responsible for KRS operations.

Recommendations

We recommend that the Audit Committee approve an annual budget of the Division of Internal Audit based on the approved internal audit plan. The Director of Internal Audit should request the amount of funds estimated to conduct the internal audits approved by the Audit Committee. Any additional funding should also be requested by the Director of Internal Audit to the Audit Committee for approval. In addition, budgeted funds should be related to completing or expanding the internal audit plan, such as expenses for external audit assistance, independent counsel, technology upgrades, or other expenditures necessary for the internal audit function to operate as approved by the Audit Committee. Once approved by the Audit Committee, the annual budget for the Division of Internal Audit should be ratified by the full Board of Trustees to be included in the KRS budget by the COO.

We also recommend that the budget for the Division of Internal Audit be well documented as a specific item in the KRS budget. The amounts available should be clearly budgeted and used by the KRS Audit Committee as a planning tool to monitor the resources that are available for the internal audit function.

Finding 8: The former Executive Director was involved in performing the evaluation of the Director of Internal Audit and did not include the full Audit Committee as required by the Internal Audit Procedures Manual.

The Director of Internal Audit has not received a performance evaluation by the full Audit Committee as required by the Division of Internal Audit Procedures Manual. Instead, evaluations were conducted by the former Chair of the Audit Committee and the former KRS Executive Director. This current practice is not in keeping with the Procedures Manual and is counter to the intentions of the Audit Committee Charter and infringes upon the independence of the Internal Audit function at KRS.

According to the Division of Internal Audit Procedures Manual, all internal audit staff are to receive the same performance evaluations as other KRS staff. The Director of Internal Audit is responsible for conducting these evaluations while the Audit Committee is to review the Director. The Procedures Manual specifically states that, "the Audit Committee reviews the performance of the Director of Internal Auditing, and the Director reviews staff's performance." The procedures do not include the Executive Director in this process. Both the former Executive Director and the Director of Internal Audit signed the Procedures Manual in February 2009 to acknowledge its adoption and should have been aware of this requirement.

The Audit Committee Charter also indicates that it is their responsibility to "review the effectiveness of the internal audit function." The Executive Director is not included in that responsibility. The purpose of this relationship is to protect the independence of the internal auditing function at KRS.

Within both the Audit Committee Charter and the Charter of the Division of Internal Audit, internal auditing is conceived and intended to be an independent function to evaluate the KRS operations. The Executive Director, who is in charge of KRS operations, should not be involved in the evaluation of the Director of Internal Audit due to the inherent conflict impacting the independence of the internal audit function. Involving the Executive Director in the evaluation of the Internal Auditor can reduce the reliability of the internal audit function.

Recommendations

We recommend that the full Audit Committee of the Board of Trustees participate in the evaluation of the Director of Internal Audit as required by the Internal Audit Procedures Manual. Members of the Audit Committee may seek input from the Executive Director or any other appropriate KRS staff, but only Audit Committee members should be directly involved in the evaluation meeting with the Director of Internal Audit. The opinions of KRS management should be tempered by the fact that the Audit Committee and the Director of Internal Audit are responsible for evaluating KRS operations.

Introduction to Findings Related to KRS Board Governance and Operational Policies

Findings 9 through 21 relate to KRS Board governance and operational policies, practices, and procedures. These findings primarily resulted from the testing performed when evaluating KRS Board activities and comparing operational policies to the 32 process and control recommendations developed and presented by the APA in the document, "Recommendations for Public and Nonprofit Boards." Chapter 2 of this report summarizes the results of this review. However, these findings also resulted from the examination of concerns raised during interviews with KRS staff and trustees. The accompanying recommendations are designed to strengthen KRS policies and thus improve the ability of the KRS Board to govern and monitor the organization.

Finding 9: KRS policy allows management to insert itself into the fraud investigation process.

KRS approved the Fraud Management Policy on May 21, 2009, that addresses allegations of fraud and illegal acts, but the required procedures mainly involve executive management and provide for only minimal input from the Audit Committee. While these procedures have never been used, inserting management into key steps of the fraud investigation process, such as determining who would participate in the investigation, management is aware of the potential fraud and the investigation findings prior to the presentation of the report to the Audit Committee. Management involvement potentially compromises the independence of the fraud investigation process. Similar to other internal audit investigations, independence from management is needed to protect the integrity of the fraud investigation process.

The purpose of the policy, according to its introduction, states, "KRS recognizes the need to maintain the public's confidence and trust in the integrity of KRS and the Commonwealth of Kentucky," and, individuals who encounter fraudulent or illegal activities "have a right to know that allegations or suspicions of impropriety will be fairly, objectively, and timely investigated." However, it is questionable whether the policy's procedures ensure that objectivity can be maintained with executive management involvement.

According to the Fraud Management Policy, the Director of Internal Audit and the General Counsel or designee will jointly review the allegations and make a preliminary determination as to how the investigation should proceed. If together they determine that a full investigation should be conducted, a team will be named to conduct the investigation. The team, referred to in KRS policy as the Fraud Investigation Team, consists of "the Director of Internal Audit or designee, the General Counsel or designee, the Ethics Officer, the Director of Information Security, Human Resources and/or other persons as designated by the Executive Director as appropriate for type of fraud alleged."

These procedures allow the Executive Director to designate the members of the Fraud Investigation Team, which could lead to internal influence within the fraud investigation. The process would be strengthened by requiring the Audit Committee to determine the composition of the investigation team. The investigative process should be led by the Director of Internal Audit under the supervision of the Audit Committee, not management. The General Counsel should be consulted on the related legal issues but should not lead the investigation.

After the investigation, the Fraud Management policy states, "the Fraud Investigation Team will prepare a report of its findings for review by the Executive Director, which will then be presented to the Audit Committee at its next regularly scheduled meeting, unless the findings require a special meeting to be scheduled." However, the policy does not clearly state the purpose of the Executive Director's review. This policy could easily allow the Executive Director to have direct input into the findings or influence the direction of the findings. The team investigating the issue should report directly to the Audit Committee.

Recommendations

We recommend KRS revise its current Fraud Management Policy to remove the requirement of an investigative team and incorporate the Fraud Management Policy fully under the internal audit function.

We recommend the Audit Committee determine whether to conduct a formal investigation based on the recommendations of the Director of Internal Audit and input from Audit Committee members.

We further recommend the Audit Committee determine the process for distributing the draft investigative report. See Finding 5 recommendations.

Finding 10: KRS policies should be strengthened to achieve greater accountability.

Through our evaluation of KRS policies relating to a number of administrative issues, opportunities were indentified for KRS to strengthen its policies and achieve greater accountability. In addition to the recommendations related to specific audit findings, there were additional policy weaknesses that should be addressed by the KRS Board. A summary of our policy evaluation is provided in Chapter 2 of this report.

Reimbursements to KRS

KRS policies do not address the timing of when staff or trustees are required to reimburse KRS for any personal expenditure that may have been incurred. A time requirement for the reimbursement of personal expenses would assist KRS in administering a reimbursement policy. The time requirement should be applicable to reimbursements of any ProCard purchases and any charges that were discovered to be personal through the travel voucher review.

Entertainment

KRS policies do not provide guidelines or maximum amounts for allowable entertainment expenses. Testing of employee expense reimbursements and ProCard transactions identified a $100.68 meal for the former CIO and two investment managers that staff characterized as entertainment. The policy does not provide adequate guidance to KRS management to define the circumstances when it may be appropriate to incur such expenses, the purpose for the expenses, and the maximum purchase amount allowed.

ProCard Support

Although the KRS ProCard policy does state, "[t]he Division of Accounting shall maintain documentation for all charges," the policy does not require supporting documentation of the charges, a deadline for this submission, or a penalty for not providing support in a timely manner. While documentation to support purchases made using a ProCard should be provided, the KRS ProCard holder is not required to submit invoices or receipts to support the charges.

Board Orientation

On November 20, 2008, KRS adopted an extensive education program for its Board trustees. While the policy requires an orientation program be completed by new trustees, the policy states that this should be done within 12 months following the date the trustee was sworn in to serve on the Board. The 12-month period for conducting an orientation for new Board trustees is too long. A trustee should receive an orientation immediately after joining the Board so that they are educated and aware of the organization's structure, budget, policies, bylaws, and other significant issues.

While discussing the orientation process with current Board trustees, we found that the orientation was typically conducted immediately upon joining the Board, but it was only conducted by the former Executive Director and the former KRS Board Chair. While it is important for the Chair and Executive Director to participate, the orientation should be facilitated by an independent, knowledgeable party and could also include the CIO and other director level staff to discuss their areas of the organization.

Recommendations

We recommend that the KRS Board revise its policies to address the timing of staff or trustee reimbursements to KRS for any personal expenditure that may have been paid by KRS. A stringent deadline should be established, as well as, the actions taken for those that do not comply with this policy.

We recommend that the KRS Board revise its policies to establish guidelines and limits on spending for the purpose of entertainment. The policy should clearly define the circumstances when it is appropriate to incur such expenses, the purpose for the expenses, and the maximum purchase amount allowed.

We also recommend that the KRS Board revise its ProCard policy to require ProCard holders to submit invoices and any other documentation necessary to support the charges made. The policy should also establish a specified amount of time allowed for this submission and the actions that will be taken for those that violate the policy.

We finally recommend that the KRS Board revise its new trustee orientation policy to require that it is performed within the first months of the trustee's service on the Board. The policy should require that the orientation be facilitated by a knowledgeable, independent party, such as a Board attorney or consultant with an emphasis on the legal and fiduciary responsibilities of Board trustees. The Board should consider requiring presentations by the CIO and other director level personnel as part of the orientation as well.

Finding 11: KRS did not consistently comply with its travel policies.

During this examination, we requested and reviewed a sample of KRS travel vouchers for the period July 1, 2007 through June 30, 2010. The samples included all travel of KRS Board trustees, Executive Directors, General Counsels, COO, former CIO, and all Investment Directors. The auditor's review of this sample did not find excessive levels of spending on travel; however, we determined that KRS did not consistently enforce its travel policies related to obtaining pre-approvals for travel and consideration of the most economical accommodations.

Obtaining Pre-Approvals for Travel

According to the KRS Travel Policy and Procedure, Section 2, "[p]rior to travel, a KRS traveler shall obtain authorization to travel on official business of KRS by the Division Director, Chief Officer and/or Executive Director of KRS or person authorized by Executive Director to grant approval for pending travel." A Request for Travel form is used to obtain the necessary pre-approvals for out-of-state travel, but the form is not required to be submitted with the corresponding travel voucher. Once approved, the forms were maintained in the executive offices and would occasionally be transferred to the Accounting Department.

Based on our audit sample, there were several instances where Request for Travel forms were not submitted along with the travel vouchers. Although KRS was able to locate a few of the missing forms, over 50 percent of the out-of-state trips taken did not have corresponding documentation to support that prior approval was obtained in compliance with KRS policy.

Additionally, the Request for Travel forms do not contain a date of the prior approval. While travelers can sign and date the request, the form does not provide a space for the Executive Director or his designee to document the date of prior approval. Therefore, while the form may be signed, there is no indication of when the form was actually approved. In discussing the prior approval of the former CIO's travel, the former Executive Director acknowledged that there were instances when he was made aware of the CIO's travel as he was walking out the door. The missing pre-approvals were not isolated and could not be attributed to just one individual. We found pre-approvals were missing for Board trustees, the Executive Directors, the General Counsels, the COO, the former CIO, and various Investment Directors.

The frequency of missing pre-approvals decreased during the fiscal years reviewed. According to the Director of Accounting, the Request for Travel forms are now returned to the individual traveler upon approval and that the traveler must submit the pre-approval form along with their corresponding travel voucher to process their reimbursement.

Consider the Most Economical Accommodations

According to the KRS Travel Policy and Procedures, Section 4, "[l]odging shall be the most economical, as determined by considering location of the lodging." According to the Director of Accounting, there is no true clear cut definition of "economical." Therefore, the determination of whether a lodging expense is economical is judgmental and the amount can vary due to location, time of year, and whether the traveler is attending a conference or business meeting.

While many trips had reasonable hotel costs, a few instances were noted where the hotel charge was higher. These instances are as follows:

- On July 10, 2007, a former General Counsel traveled with the former CIO to an investment related meeting in New York. Lodging costs at a hotel that referred to itself as a "luxury hotel" off Madison Avenue were $349 before taxes the first night, and $379 before taxes the second night, for a total cost of $1,664.74. The trip was for a business meeting and not a conference or seminar.

- On November 4, 2007, a former General Counsel traveled to Washington, D.C. for business related to a Supreme Court case. The hotel charge was $323 per night before taxes for total of $742.98 after taxes. The General Counsel returned to Washington, D.C. for the same purpose and stayed in a different hotel for $149 per night.

- On September 23, 2008, the former CIO traveled to Chicago, IL to meet with the KRS custodial bank and perform due diligence reviews. After tax, the hotel cost KRS $448.91 for that single night.

- On September 17, 2008, the Director of Equity Assets and another investment staff member traveled to New York for a due diligence meeting and stayed one night at a hotel commonly used by KRS staff. In this instance, the room rate, which is typically much lower, was $579 before taxes. The cost of the two rooms totaled $1,319.88 after taxes were applied. According to staff, the trip was booked at the last minute and there were no rooms available at the state government rate. The hotel was within walking distance of the meeting and would not require additional transportation. This lodging rate was provided on the Request for Travel form; however, no documentation was provided that optional room rates were given. The form was signed by the former CIO but not by the former Executive Director or his designee as required by policy.

In each of these instances above, the trips were not pre-approved as required by policy. Had the travel policy been enforced, these trips would have been pre-approved and the economical cost of lodging would have been considered.

Recommendations

We recommend that KRS enforce its policy requiring pre-approval for travel and the reviewer consider whether lodging is the most economical for the location. Any travel expenditures incurred without proper pre-authorization should be brought to the attention of the KRS Board for determination as to the appropriateness of the trip and related expenses.

We recommend that the KRS Board revise its travel policies to require that Request for Travel forms be submitted along with the travel vouchers to ensure that employees only receive reimbursement for the business related expenses that were pre-approved.

We recommend that KRS revise its Request for Travel forms to include a space for the Executive Director or his designee to document the date of approval.

Finding 12: KRS policies did not require all members of the executive staff, including the Chief Investments Officer, to complete a conflict of interest statement.

The KRS Conflict of Interest and Confidentiality Policy Section 4 (1) requires the Executive Director and KRS Board trustees to complete a written conflict of interest statement. While other KRS policies that apply to the KRS Board and Executive Director also apply to executive staff, including the CIO and General Counsel, the conflict of interest and confidentiality policy does not. Section 4 (3) of this policy states, "[o]ther employees of KRS may also be requested to file a written conflict of interest statement as needed or requested by the Board." However, according to KRS management, a written statement was not requested of any other individuals within KRS during the examination period.

The Conflict of Interest and Confidentiality Statement itself is a prepared form that contains language stating that the individual acknowledges their obligation to "diligently identify, disclose, avoid and manage conflicts of interests." The form does not require actual disclosure of any relationships or actions which may present potential conflicts.

Despite the recent industry-wide concerns surrounding investments in public pension systems, KRS did not require a written conflict of interest statement from its CIO and Investment Division Directors who routinely interact with investment managers and marketers. The KRS General Counsel, who would actively be involved in negotiating contracts with investment managers, was also not required to complete such a statement.

The main issue in the debate over using placement agents is whether the investment decision was made by someone with a conflict of interest. Given the concerns related to the use of placement agents and any prior relationships with KRS employees, KRS would benefit from having its key executive staff, especially those involved in the investment process, complete a conflict of interest statement.

Recommendations

We recommend the KRS Board revise its conflict of interest policy to include, at a minimum, a requirement for the CIO, Investment Directors, and General Counsel to file an annual written conflict of interest statement.

We further recommend the KRS Board expand upon its conflict of interest statement to allow for an actual listing of relationships or actions that may cause a potential conflict. The form should identify the types of relationships and actions that should be disclosed, such as investments, past work relationships, political contributions, speaking engagements, gifts, or other potential conflicts of interest that may be of possible interest to KRS. This form should allow the individuals to provide a brief description of the relationship or action listed and should be regularly updated by individuals as their circumstances change.

Finding 13: The KRS Conflict of Interest and Confidentiality Policy does not specify a penalty for violating the policy.

In 2009, an active trustee inquired about jobs with KRS investment contractors and informed the media of a planned investment manager contract termination prior to the KRS Board meeting. To address these actions, the former KRS Board Chair removed this trustee from the Investment Committee and filed a formal complaint with the Executive Branch Ethics Commission (Commission); however, these actions are not documented in the KRS Board minutes. The KRS Conflict of Interest and Confidentiality Policy does not specify a penalty for violations. Without a stated penalty for violating this policy, it is difficult for the KRS Board to openly discuss the issue and to determine the appropriate response to a violation of the policy.

There are two sections of the KRS Conflict of Interest and Confidentiality Policy that stipulate the requirements that relate to the known conduct of a certain KRS Board trustee. According to Section 2 (7), "[i]ndividuals must avoid all conduct which in any way might lead the public to believe that the individual is using his or her position with KRS to further a professional or private interest." In addition, Section 3 (3) states that, "[t]hese individuals have a duty to keep confidential the information to which they are granted access as a result of their association with KRS." Further, Section 1.2(m) of the Board bylaws states, "[t]he Board, or individual members of the Board, shall refer all news media inquiries to the Executive Director and shall not discuss matters that affect the Systems or the Board generally with the news media." However, the policy is silent as to what actions should be taken if these requirements are violated.

On February 5, 2009, the Board trustee emailed two companies that contract with KRS seeking work and provided his resume. In one email the Board trustee states, "[o]n another completely different note I am doing some free lance consulting and expert witness work. If you have any ideas for me in the non-real estate area I would appreciate it. I would be interested in DOL work. I have attached my resume for your reference. I am also looking for full time work as well." In a separate email to another KRS contractor on the same day, the trustee attached his resume and stated "[l]et me know if I can be of assistance."

The Board trustee's actions give the appearance that he is using the contacts he has made through his time at KRS and his Board position in an attempt to further his professional career. This appears to violate KRS policy despite the Board trustee's statement that he was seeking work with other pension funds, not the consultants, and that he sees no evidence that money passed between him and the contractors.

On August 5, 2009, a day before the next quarterly meeting of the KRS Investment Committee, the trustee sent an email to an individual outside of KRS containing a "Release to Press," which stated, "KRS Investment staff will recommend that [ ] be fired Thursday of which I am supportive of." The following day in the Investment Committee meeting, a motion was made to terminate the contractor in question, which was then seconded by the trustee and the motion passed. While this action became public knowledge, the email was sent prior to any action being taken by the KRS Board.

Based on interviews, the APA was informed that the former KRS Board Chair removed the trustee from the KRS Investment Committee after the August 6, 2009 meeting. Board meeting minutes do not document that this action was presented to the Board. As well as the removal, the former KRS Board Chair filed a formal complaint with the Commission.

The trustee provided the APA with the trustee's response to the complaint filed with the Commission. According to this information, the trustee "was looking for jobs or contracts from other pension plans not the contractors" and he considered the contact to be "normal networking." The trustee also wrote that, "I see nothing that shows money has ever passed hands from any KRS contractor to me or my business. It makes no sense; the contractors mentioned would lose their contract with KRS if they engaged in this behavior."

The KRS trustee's response to the Commission in part stated, "[w]hy is this confidential, terminations and hirings of managers are typically published in several investment industry publications and are considered public knowledge." The trustee also stated in his response that he had questioned the agency's hiring of the contractor and had wanted to discuss the matter before the contractor was "quietly fired and all the information was buried and covered up." He stated that the media was his "only ally on getting this information disclosed since the rest of the board is actively trying to cover this up."

In April 2010, due to a new statutory requirement, enacted on April 12, 2010, that the Investment Committee have two members with an investment background, the trustee was again appointed to the Investment Committee. Additionally, the complaint was considered by the Commission, but it was subsequently terminated as the actions of the Board trustee were not found to be in violation of Executive Branch Ethics Code.

While the actions of the individual KRS Board trustee were found not to violate Executive Branch Ethics Code, certain actions included in the complaint to the Commission do appear to be a violation of the KRS Conflict of Interest and Confidentiality Policy. The work inquiries can be perceived to be the individual using his or her position with KRS to further a professional or private interest. The prior announcement of Board actions to the media is not maintaining the confidentiality of information known as a result of an access to information granted as a result of his or her association with KRS. While the appearance of a conflict does not necessarily indicate an actual conflict, it does indicate that the situation could lead a reasonable person to believe there is a conflict. Additionally, there is no evidence that the Board trustee received any work in association with these emails, nor is there evidence that the contractors were affected either positively or negatively by this situation.

The action taken by the former Board Chair to remove the trustee from the Investment Committee, as a result of these policy violations, was not presented to the Board in a public session. Therefore, the KRS Board meeting minutes do not document that a trustee violated KRS Board policy or that the trustee was removed from the Investment Committee. If this was not documented, there is a concern that violations of KRS policies and the resulting actions may not be publicly acknowledged.

Recommendations

We recommend that KRS Board trustees comply with all KRS Board policies and not use the trustee position to improve his or her professional interest. If the trustee's career is in the investment industry, extra caution is necessary to avoid the appearance of conflicts.

We recommend trustees follow the KRS Board bylaws to refer all news media inquiries to the Executive Director and do not discuss matters that affect KRS or the Board generally with the news media.

We also recommend that the KRS Board revise its Conflict of Interest and Confidentiality Policy to include specific penalties or a process to be followed when a trustee is found to have violated policy requirements or bylaws.

We further recommend that trustee disciplinary actions taken as a result of policy violations be disclosed during a public KRS Board meeting and that the action be documented in the Board meeting minutes.

Finding 14: KRS Procurement Policy authorizes KRS to spend funds for employee prizes, gifts and service awards.

Testing a sample of KRS ProCard transactions for the period July 1, 2007 through December 31, 2010, revealed that KRS routinely purchased employee retirement gifts, prizes, and service awards for its staff. This practice is allowed by the KRS Procurement Policy and is exempted from competitive sealed bids. Regardless of whether KRS complied with its policy, these purchases are personal in nature and are not a necessary business expense that provides benefit to KRS members.

Under KRS Procurement Policy, Section VII Exceptions to Sealed Bidding, KRS defines certain purchases to be provided to employees that are exempt from competitive sealed bidding. This section of the procurement policy states:

> Other procedures exempt from competitive bidding include those gifts provided to employees of KRS as described below. Therefore KRS exempts from competitive sealed bidding the following specific items:
>
> 1. Upon retirement, KRS may provide a gift of tangible personal property to an employee retiring from KRS based upon the number of years of service to KRS. A gift in the amount of $50 for each five years of service to KRS may be presented, not to exceed $200. Approximately $50 for the cost of a reception may be provided should the employee choose to have one. If he or she chooses not to have a reception, the $50 toward the cost will be forfeited.
>
> 2. KRS may provide a flower bouquet to family of a deceased KRS employee, the cost of which shall not exceed $50.

3. Nominal value prizes, such as t-shirts, mugs, writing portfolios, etc, may be awarded to KRS employees on a random basis each month.

4. Periodically, KRS may sponsor "parking lot picnics" or other nominal food gifts in appreciation for the service of KRS employees.

5. These gifts are excluded from the employee's taxable federal and state income consistent with Internal Revenue Services Publications 525 and 535.

Expenditures for retirement gifts, monthly prizes, and service awards given to KRS employees were reviewed within our sample of ProCard transactions. While retirement gifts included larger ticket items such as a digital camera, a camcorder, and rocking chairs, monthly novelty prizes and service awards included t-shirts and $25 restaurant gift certificates, respectively.

The expenditures tested complied with the guidelines established through KRS policy. For example, KRS did not exceed the $200 maximum for two employees that retired with over 20 years of service. Based on our review of ProCard invoices, purchases that exceeded the above policy limits included documentation that the additional amount had been paid from the personal funds of KRS staff and not from KRS agency funds.

Recommendations

We recommend that the KRS Board revise its procurement policies to no longer allow pension funds to be spent on monthly prizes. In lieu of using pension funds for retirement gifts, receptions, or other service recognition awards, KRS employees should be limited to receiving a certificate or plaque. If KRS staff would like to continue providing these awards, prizes or gifts, the expense should be collected from personal funds rather than at the expense of KRS members.

Finding 15: KRS had no established method for employees and citizens to anonymously report concerns.

The KRS Fraud Management Policy established on May 21, 2009, did not include a process for individuals outside of KRS, such as citizens and contractors, to anonymously report concerns pertaining to potential fraud, waste, or abuse within KRS. The process established through the Fraud Management Policy is very specific to employees and how they may report matters through the structural hierarchy of KRS, with certain exceptions if reporting to a specific individual would create a conflict of interest. While this policy does state, "[t]he identity of any reporting individual and/or suspected individual will be kept confidential to the extent possible," the policy does not outline a means by which an employee or other individuals may report concerns without having to share any personal information.

On May 21, 2009, KRS established a formal written policy documenting the process by which an employee concern of fraud or illegal acts can be reported and the internal process for evaluating and investigating such a concern. Per the KRS Fraud Management policy, if an individual has a concern relating to fraud or an illegal act they should resolve the concern by discussing it with a supervisor or director. If the concern relates to a supervisor or director, then the concern should be discussed with the Executive Director. If the concern relates to the Executive Director then the individual should report the matter to the Director of Internal Audit, and finally, if the matter involves the Director of Internal Audit then the individual should report the concern to the Chair of the Audit Committee.

According to the Director of Internal Audit, the KRS internet website had included, at one time, a means by which individuals could report concerns anonymously to KRS. The website, created in late 2008, provided individuals with the mailing address of the Internal Auditor through which anonymous concerns could be expressed. The KRS website was updated in August 2009, converted from a "dot (.) com" to a "dot (.) gov" website address designation. According to the Director of Internal Audit, the information included on the previous website has gradually been placed on the current website. However, the process to report an anonymous concern has not been included on the new KRS website.

Despite having a specific reference for reporting anonymous concerns on the previous website, employees we interviewed were not aware of an anonymous method for reporting concerns. Further, KRS policies do not include a documented process that would reflect the information that was temporarily made available on its website.

The Board and its organization would benefit from the creation of an anonymous reporting mechanism to allow for anonymity to individuals who wish to report a concern to KRS and its Board. The mechanism established to receive concerns should be multifaceted in that there should be more than one means available to individuals to voice a concern, such as, through a hotline number, an email address easily accessible through its website, and a postal address for receipt of letters or other documentation individuals want to share with KRS to support their concern. The Board would need to designate a person or persons to specifically receive these concerns.

While the current Fraud Management policy does include a statement indicating that individuals acting in good faith in reporting a concern will not be subject to retaliation or reprisal, additional language to clearly document employee protections available under the Kentucky Whistleblower Act would be beneficial. Without direct reference to this act, employees may not be sufficiently aware of their rights.

Recommendations

We recommend the KRS Board create a multifaceted process through which KRS and its Board can effectively receive anonymous reports from individuals within and outside of its organization. While this may be accomplished through revising its current Fraud Management Policy, the expanded policy should ensure that the process is sufficiently independent to offset any risk of internal influence over the fraud investigation process. See Finding 9.

We further recommend the KRS Board ensure that the process for anonymously reporting concerns is formally documented in KRS policies and properly disseminated to its employees and made available the public. The information should be easily accessible through the KRS internet website. We also recommend KRS consider including this information when issuing newsletters to its members.

We finally recommend that the KRS Board include additional language in its policy to clearly document the employee protections that are available under the Kentucky Whistleblower Act.

Finding 16: Routine reporting to the Board is not sufficient.

While the KRS Board receives information from individuals and groups both inside and outside of its organization, certain operational information was not routinely reported, or in some cases was not reported at all. From our interviews with KRS Board trustees, one of the consistent comments was that they receive a lot of information. However, the information provided could be more informative and valuable to the KRS Board in providing oversight to the organization.

In addition, it was found that healthcare administrative expenses are not included in the budget provided to the KRS Board or the General Assembly. However, the KRS Comprehensive Annual Financial Report does include healthcare administrative expenses as part of KRS' total administrative expenses. In addition, KRS 61.645(13) requires that all expenditures relating to the administrative operations of the system be contained in the biennial budget request adopted by the General Assembly. According to KRS, only the administrative expenses that are paid from the retirement system's pension funds are presented because contributions for the purpose of paying health benefits must be maintained in the insurance trust funds and not commingled to pay pension benefits. Without affecting the account used to pay expenses, healthcare administrative expenses can be disclosed to the KRS Board and General Assembly to ensure that they are aware of the amount budgeted for the cost of operating the health insurance portion of the retirement system.

Budget to Actual Reporting

KRS staff does not routinely report budget-to-actual information to the KRS Board. According to the COO, who is responsible for the budgeting process, the KRS budget was approved by the Budget Committee and then ratified by the full KRS Board. The COO stated that while the KRS Board did not receive any formal reports of budget-to-actual expenditures, he stated "I routinely tell them where we stand vis-à-vis the approved budget as a whole."

The COO stated that he prepared a spreadsheet indicating the projected year-end figures and presented this to the former Executive Director near the end of the fiscal year. However, this information was not presented to the KRS Board.

The KRS Board's responsibility for the KRS budget currently ends with the request and approval process, but their responsibility should extend to monitoring the budget to ensure that KRS is operating within established parameters. Effective oversight requires the Board to review budget-to-actual information and discuss any variances or other financial-related issues with the Executive Director and other KRS personnel.

Direct Investment Expenditures

As discussed in Finding 17 of this report, the KRS Board is not presented with any information related to investment expenditures, which includes the travel expenses incurred by KRS Investment staff. These expenditures are not incorporated in the KRS budget because the budget only includes administrative expenditures. Even if budget-to-actual reports are presented, investment expenses will not be included. The KRS Board and its Investment Committee should monitor investment expenditures along with travel activities to ensure that KRS staff are held accountable for the costs incurred.

Executive Salaries

The KRS Board approved the KRS salary structure, approved the annual pay raises, and approved increment increases for KRS staff. However, this approval process is performed at an organization level and not for individual salaries. The KRS Board should be aware of the salaries paid to the executive staff, but the individual salaries of all KRS staff do not necessarily need to be reviewed by the KRS Board. As has been clarified by OAG Open Records Decision 11-ORD-049, all salaries are open records and subject to public inspection.

Recommendations

We recommend that KRS include the administrative costs to operate the health insurance portion of the retirement system in the KRS budget that is approved by the Board and General Assembly.

We recommend that the KRS Board require staff to provide to the Board quarterly budget-to-actual expenditure reports. This report should be detailed by budget line item and should include an explanation for significant variances.

We also recommend that the KRS Board require staff to provide to the Board quarterly investment expenditure reports. This report should present investment costs by expense category so that specific investment activities can be monitored by the KRS Board. Expenses paid from the pension and insurance fund should be monitored by the KRS Board.

We further recommend that the KRS Board require staff to provide to the Board an annual report of executive staff salaries. The report should provide their salaries for a three-year period to allow for comparative data and fully disclose salary data. The KRS Board should request additional salary data on all KRS staff as needed in their review of the KRS salary structure.

Finding 17: KRS does not budget for investment administrative expenditures such as travel, education, and conferences.

KRS budgets for general administrative expenses: however, direct investment expenses are not included in the KRS budget approved by the KRS Board. By not including the investment expenses in the budget process, these expenses are not presented within specific activity categories. In addition, KRS does not maintain a comprehensive list of investment travel and meetings that could document the necessity and effectiveness of the costs incurred. Investment costs are allocated as expenditures from both the pension and insurance funds but only limited monitoring can be conducted by the KRS Board and its Investment Committee.

According to the KRS COO, who is responsible for budget development and oversight, there is no budget or report of investment administrative expenses by category. The possibility of budgeting for investment travel, conferences, and educational expenses, as well as performing a periodic review and reporting of those expenditures to the Investment Committee, was discussed with the former CIO, but no actions were taken.

The two reasons provided by the COO for the lack of investment budgeting were that the former CIO had other priorities and that the uncertainties related to these investment costs would make it difficult to budget. According to the COO, to include this information in the biennial budget approved by the KRS Board and General Assembly, KRS staff would be required to estimate the amount of funds needed for investment travel, training and other investment related costs for a two-year period. Further, the COO stated it would be extremely difficult to budget for these costs because of uncertainties about when money will be invested and with whom and determining what due diligence trips to investment manager offices would be necessary.

To review investment travel to identify questionable trips and costs, a comprehensive list of meetings was requested. Because this list was not maintained, the APA had to review a combination of travel vouchers and ProCard transactions in an attempt to identify questionable activity. While we were unable to verify the population of investment related trips, KRS accounting records document that investment travel was $44,564, $38,963, and $34,857 for FY 2008, FY 2009, and FY 2010, respectively.

Travel vouchers and applicable ProCard expenditures of the former CIO and investment directors were examined for the period July 1, 2007 through June 30, 2010. These expenditures were examined to determine whether the expected costs for meals, transportation, and accommodations were paid by KRS and not by another entity desiring to influence KRS investments. From the testing performed, instances were identified in which a traveler was out-of-state, yet there were no expenses charged for accommodations. There were also instances in which payment or reimbursement for meals was not made for an entire day, either on a travel voucher or through a ProCard purchase.

The instances in which accommodations were not accounted for, and most of the instances in which meals were not charged for an entire day, were associated with the travel of the former CIO. The former CIO held a KRS ProCard to directly charge travel costs and also submitted travel vouchers for reimbursement of per-diem meal costs, tips, and other expenses. This complicates the review process because ProCard charges and travel vouchers are reviewed and processed separately by KRS, making it difficult to detect discrepancies.

Travel records did confirm that several of the nights in which the former CIO did not incur expenses for hotel accommodations were on weekends. In one instance, the former CIO noted that personal leave was being taken on three specific dates of the trip; however, according to payroll records, leave was not requested and leave balances were not reduced for those three days. Regarding meals, the former CIO charged per diem meal costs on weekends, yet no overtime was charged for working on those days. Due to the lack of documentation detailing the daily activities of this trip, we were unable to determine whether the per diem amounts paid were appropriate. We also identified one instance where a meal charge was paid through the ProCard and a per diem amount was also reimbursed to the former CIO for the same meal period.

The transparency of the investment process is reduced when meetings and travel details are scheduled by each individual without a comprehensive record that can be reviewed and analyzed. The oversight of investment travel could be strengthened if all investment staff were required to provide meeting locations and dates in advance and then report the total costs incurred once the meeting or trip was completed. This information could be maintained by a central staff person, reviewed by the CIO, and monitored by the Investment Committee.

The COO has discussed the need for monitoring and reporting investment expenditures with the new CIO, who agreed that a monitoring and reporting process should be developed. According to the COO, the KRS Accounting Department will report investment expenses monthly to the CIO, effective immediately. The CIO will then report this information to the Investment Committee at its quarterly meetings.

While some investment costs are complex and speculative in nature, KRS would benefit by budgeting the costs related to investment travel, training, and education. A budget with a specific amount for investment travel would establish parameters that can be used by investment staff to control these costs. It would also hold KRS more accountable for such costs and provide for greater transparency.

Recommendations

We recommend the KRS Board adopt a budget that includes certain investment related expenses such as travel, education, and conferences that are not already included in the KRS budget. This budget should be monitored by the KRS Board to document their awareness of the funds used for investment purposes.

We also recommend KRS staff provide regular quarterly reports to the KRS Investment Committee and full Board of budget to actual investment expenditures. The reports should be formatted in a clear and concise manner to facilitate the committee members' review of these expenditures made from various pension and insurance funds.

We also recommend that KRS ensure that personal trips taken in association with business travel be clearly identified and that leave balances be reduced as appropriate. The purpose of the daily travel, as stated on the travel voucher, should be an accurate and concise representation of the traveler's activity on that day.

In addition, we recommend that KRS create a consolidated database to formally document meetings and costs incurred by KRS investment personnel. Staff should be appointed to record this information and maintain the database. Information on meetings, either local or out-of-state, should be provided in advance to ensure that all meetings are known and documented. The actual costs incurred for a meeting should be recorded in the database so that a complete record is maintained for monitoring and budget purposes.

We further recommend that KRS provide regular reporting to its Investment Committee members detailing the investment meetings conducted and the costs incurred by KRS investment staff, including the CIO. This report should contain the date of the meeting, the purpose, the location, and the associated costs. This report should be presented for informational purposes to allow for discussion of the effectiveness of the meeting and to ensure additional accountability and transparency.

Finding 18: KRS Board meeting minutes were not completed in accordance with the Board bylaws.

In reviewing KRS Board meeting minutes for the period July 1, 2007 through December 30, 2010, we found several instances of meeting minutes not presented or amended in a timely manner as required under the Board's bylaws. The KRS Board of Trustees Statement of Bylaws and Committee Organization states, "[t]he Executive Director shall cause the minutes to be transcribed and presented for approval or amendment at the next regular meeting."

While the minutes of the Audit and Human Resources Committees were consistently transcribed and presented in accordance with the KRS Board's policy, the minutes of the full KRS Board and its Investment Committee were not. During the time period under review, approximately nine out of 28 full KRS Board meetings and seven out of 22 Investment Committee meetings did not have the minutes transcribed, presented, or amended by the next regular meeting of those bodies.

According to the former Executive Director, the minutes of each KRS Board and committee meeting are transcribed by his assistant in preparation for presentation to those bodies for review and approval. He acknowledged that on occasion the minutes were not transcribed and presented timely and that he had received complaints from KRS Board trustees. The former Executive Director pointed out that the audio recordings of the meetings were available even when the meeting minutes had not yet been transcribed and presented for approval.

While audio recordings do provide detailed oral documentation of each meeting, the written meeting minutes provide a summary of the significant discussions and formal actions taken by the KRS Board. Audio recordings may capture the discussion in total, but the recording does not inform the listener of who was speaking and it does not clearly identify how each KRS Board trustee voted. The written meeting minutes should clearly document which KRS Board trustees made and seconded motions, as well as how each trustee voted on a particular motion. In this way, KRS Board trustees' activity is documented and the trustees are on record as being accountable for their actions at the meetings.

Through interviews, the individuals responsible for transcribing the minutes attributed an extensive workload and internal review process for the difficulty in presenting the minutes before the board in a timely manner. These individuals noted that the volume of minutes to be transcribed could vary depending upon the number of special KRS Board and committee meetings. The internal review process may include reviews by chief officers, General Counsel, Executive Director and others. In some instances, it was difficult to get feedback and approval to proceed from everyone in the review process in a timely manner. In addition, one individual indicated that the details required to be included within the minutes would dictate how long the process would take to complete.

The review and approval of the written KRS Board meeting minutes allows the trustees an opportunity to ensure that the minutes are complete and correct. In order for this process to be effective, the minutes should be presented timely to ensure that the trustees are able to remember the details of the meeting. Given the magnitude of information presented and the fact that the full KRS Board and its committees may meet less than five times a year, this documentation is necessary for the KRS Board trustees and for those that could not attend a meeting but are interested in the discussion and actions taken at the meeting.

Recommendations

We recommend that KRS staff ensure that KRS Board meetings and its committee meetings are transcribed in a timely manner as prescribed and required by the KRS Board bylaws. The appropriate number of KRS staff should be assigned the responsibility of transcribing the meeting minutes to ensure that there is adequate coverage based on the number and length of full KRS Board and committee meetings. The internal review process of the draft meeting minutes should also be evaluated to ensure that an effective and timely process is in place.

Finding 19: The KRS Board election and appointment process is inconsistent.

A review of KRS Board trustee requirements identified opportunities to make the KRS Board trustee election and appointment processes stronger and more consistent. Processes that could be strengthened include the application process, assurance of trustee qualifications, and disclosure of relevant information to members.

Application Process

The process to become a KRS Board trustee differs depending on the manner in which the individual joins the Board. Those individuals interested in appointments by the Governor to boards and commissions, including the KRS Board, must submit an application and current resume to the Executive Director for Boards and Commissions within the Governor's Office. In addition to the request for personal, political, and educational information on the standard application form for all appointments, the applicant must indicate whether they have ever been convicted of a felony and must authorize the Governor's Office to conduct a "complete check" on their background. According to the Governor's Office, the General Counsel's Office conducts a background check searching civil and criminal databases that contain information from across the country. A background check is conducted at the time the applicant is recommended for appointment and the results are considered in evaluating the potential appointment.

In contrast, individuals interested in being elected to the KRS Board are not required to disclose felony charges or to authorize a background check to be performed when applying to be nominated to the KRS election ballot. According to the KRS interim General Counsel, "the only information submitted by the potential candidate for elected trustee is a resume. The Board does not receive any additional information about the potential candidate. There is no formal application and no background check."

Assurance and Disclosure of Trustee Qualifications

Knowledgeable and experienced trustees are needed to ensure that KRS assets are managed appropriately. Elected trustees have no qualification requirements; however, the qualifications required for appointees to the Board, as dictated by statute, strive to ensure that the KRS Board possesses the investment background needed to effectively oversee KRS.

According to KRS 61.645(1)(e), of the three (3) trustees appointed by the Governor:

1. One (1) trustee shall be knowledgeable about the impact of pension requirements on local governments; and,
2. Two (2) trustees shall have investment experience. For purposes of this subparagraph, a trustee with "investment experience" means an individual who does not have a conflict of interest, as provided by KRS 61.655, and who has at least ten (10) years of experience in one (1) of the following areas of expertise:

a. A portfolio manager acting in a fiduciary capacity;
b. A professional securities analyst or investment consultant;
c. A current or retired employee or principal of a trust institution, investment or finance organization, or endowment fund acting in an investment-related capacity;
d. A chartered financial analyst in good standing as determined by the CFA Institute;
e. A university professor, teaching economics or investment-related studies; or,
f. Any other professional with exceptional experience in the field of public or private finances.

Disclosure of Relevant Information to Members

The KRS website does not disclose the qualifications of each KRS Board trustee. Current information on the KRS website includes the trustee's picture, name, term expiration date, and whether the board trustee was appointed or elected. Disclosing on the KRS website trustee information such as education, work history, investment experience, and involvement with pension systems increases transparency and better informs retirees and other interested parties.

Recommendations

We recommend the same disclosure requirements and application process be followed for both appointed and elected KRS Board trustees. At a minimum, these requirements should include a current and detailed resume, a cover letter detailing the applicant's specific qualifications to be an effective KRS Board trustee, authorization for a background check, acknowledgement of any felonies, and a formal application. We recommend this information be provided by potential appointees and election candidates at the initiation of the application process or election process.

To ensure a consistent process, we recommend KRS perform a background check of candidates for elected trustee. This check should be performed and the results distributed to the KRS trustees prior to considering candidates that will be placed on the election ballot.

We recommend that the KRS Board document background, experience, and qualifications for each trustee on the website's "Meet the Board" page.

Finding 20: KRS bylaws do not limit the number of terms an individual may serve as Board Chair or Vice Chair.

The KRS Board bylaws state that the Chair and Vice Chair "may be elected to successive terms in office." This policy does not specify the number of successive terms that a Board Chair or Vice Chair can serve. The former KRS Board Chair served fourteen consecutive terms as Chair. The position of KRS Board Chair should be term-limited to reduce the actual or perceived control held by one individual. During the 2011 Regular Session of the General Assembly, House Bill 460 was introduced that included a six consecutive term limit on the position of Board Chair; however, this legislation was not successful. If legislation limiting the terms of the Board Chair and Vice Chair is not passed, terms limits could be imposed by a vote of the KRS Board.

A term for a Board Chair and Vice Chair is for one year, for the period beginning the first meeting in April until March 31 of the next year. The KRS Board Chair has typically made the committee assignments, selected the Committee Chair, and determined when special meetings are called. Being in the position of Board Chair or Vice Chair for an extended period of time can result in allegiances and familiarities with other trustees and KRS staff that may not be beneficial to KRS as a whole. If this control is not periodically rotated to other trustees, a board can become divisive if there are trustees that feel powerless to make changes.

Recommendations

We recommend a maximum number of terms be established for an individual to successively serve as Board Chair or Vice Chair. If legislation is not passed, we recommend that the KRS Board vote to limit the terms of the Board Chair and Vice Chair. In selecting the term limit for the Board Chair, a balance is needed to ensure stability but to also rotate the concentration of power held by one individual.

Finding 21: Additional external audit services would assist the KRS Board in strengthening oversight of its operations.

The only type of audits conducted at the request of the KRS Board was a financial statement audit and no additional audits have been requested. Several procedures were performed by the APA to evaluate the adequacy of the audits conducted including a comparison to other public pension plan audits relative to audit cost and hours, a review of the KRS request for proposal (RFP) process, and a review of the independent auditor's workpapers. During our review of audits performed of other state's pension plans, we noted various types of audits conducted that would be beneficial for KRS. Given the current economic condition and the tenuous financial positions of many public pension plans, including KRS, further examinations or reviews could be used to ensure the effectiveness of internal controls, compliance with investment policies, soundness of the internal audit function, and adherence to industry best practices.

Our review found no significant differences in the cost and hours of the KRS financial statement audit to the financial statement audits of other state's public pension plans similar to KRS in asset and member levels. Because many retirement systems, including KRS, rely on a third party custodian to assist in the management of the plan's assets, complex investment transactions are booked by the third party. These transactions are included on the third party's financial statements and tested for proper compliance during that organization's financial statement audit, which contributes to a reduced price for the KRS audit.

After a review of the RFP process for a KRS external auditor, we found that the RFP was written adequately to receive and obtain the necessary financial audit services. In addition, the evaluation and scoring of the proposals was documented and complied with requirements.

The working papers of the independent external auditor conducting the FY 2010 financial statement audit were reviewed on location. The audit conclusions were supported by the working papers and the audit procedures performed appear appropriate for a retirement system.

While the KRS financial statement audit was comparable in costs and hours to other states' audits, the KRS Board has not requested any additional audit services. A financial statement audit does not address all management areas that benefit from an independent audit, unless the audit scope is adjusted by the KRS Audit Committee at the time the auditor is engaged. The various types of audits that can be requested by the KRS Board include the following:

Financial Statement Audit – A financial audit done in accordance with government audit standards looks at (1) whether the audited organization's financial statements are fairly presented in accordance with applicable accounting principles, (2) whether there are any significant problems with the organization's internal controls, and (3) whether the organization complied with applicable legal requirements. KRS received this type of audit annually.

Performance Audit - A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Compliance Audit – A compliance audit is undertaken to confirm whether an entity is following the rules and regulations applicable to an activity or practice prescribed by an external agency or authority.

Management Audit – A management audit is an assessment of methods and policies of an organization's management in the administration and the use of resources, tactical and strategic planning, and employee and organizational improvement. The objectives of a management audit are to (1) establish the current level of effectiveness, (2) suggest improvements, and (3) establish standards for future performance.

Special Examinations – Special examinations are performed in response to concerns expressed by interested parties about particular issues or to address specific allegations presented by whistleblowers and concerned citizens.

The audit inquiry sent to other states to facilitate a comparison of audit costs and hours also included a request for the most recent audits conducted of the state's retirement system. Our review of these audits found that certain states conducted more than just the basic financial statement audit for their retirement system. These states and the additional audits are listed in the following table.

Table 17: Additional Audits Conducted for Other State's Retirement Systems

State	Additional Audits/Examinations
Illinois	In 2011, a Compliance attestation examination to determine whether the retirement system obligated, expended, received, and used public funds in compliance with the statutes.
Pennsylvania	In 2006, a Performance audit of the retirement system by the State Auditor's Office and a Fiduciary review of the retirement system by a third party.
Utah	In 2009, a Performance audit comparing administrative and investment costs of the plan to other retirement plans. In 2003, a Performance audit of the investment practices of the retirement system was conducted.
Minnesota	In 2008, an Information Technology audit was conducted of the state retirement system.
Wisconsin	Statutes now require a biennial management audit of the retirement system board.
Oregon	In 2007, a Computer Application Controls review was conducted. In 2004, a Change of Director review was conducted.
Nebraska	In 2006, a Performance audit related to compliance, the PIONEER computer system, and management was conducted.
West Virginia	In 2007, a post audit examination was conducted of the retirement system's expense fund covering a two-year period.

Source: Auditor of Public Accounts based on information provided from other states through an audit inquiry administered by National Association of State Auditors, Comptrollers and Treasurers.

Recommendations We recommend that the KRS Board Audit Committee seek, at least periodically, more than just an external financial statement audit of the retirement system. With additional external audit services, the Board could obtain a more in-depth analysis of any function or aspect of the retirement system (administrative, investment, or benefit delivery), comparison of policies to practice, and gain valuable insight into how operations might be improved as well the best practices identified in other states.

EXHIBITS



Kentucky Retirement Systems
Frankfort, Kentucky

Placement Agent Audit
For the period July 1, 2004 through September 30, 2009

Ann M. Case
Compliance Officer

July 14, 2010

Kentucky Retirement Systems
Executive Summary
Placement Agent Audit

I. Scope and purpose

The purpose of this review was to look back at the relationships Kentucky Retirement Systems (KRS) had with placement agents in order to have a better understanding of the involvement placements agents have when hiring external managers for our asset classes. The Placement Agent Audit was performed by reviewing the policies and procedures in accordance with Government Finance Officers Association (GFOA) Best Practices for Public Employee Retirement System Investments, GFOA Best Practice for Public Employee Post-Retirement Benefits Systems. The review consisted of an extensive examination of various documents, investment policy, Placement Agent policy, confirmation from Investment Managers/General Partners, interviews with Investment Staff, interviews with outside consultants and an interview with a Placement Agent. The focus of the review was primarily on the use of Placement Agents in the hiring of External Investment Managers. This examination was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*, as published by the Institute of Internal Auditors.

II. Conclusion

Over the past few years, KRS has sought to diversify the KRS Portfolio by focusing on the Alternative Asset Class. The increased activity within the Alternative Portfolio has resulted in an increase in the involvement of placement agents. Private Equity Investments are typically not publicly traded and often times require the use of Placement Agents in the hiring of new Investment Managers/General Partners. There has been one placement agent who has been involved more frequently than others. The frequent use of one Placement Agent gives the appearance of preferential treatment; however, based upon the audit test performed, no evidence was discovered that would indicate impropriety.

KRS has been proactive in developing a Placement Agent Policy; however, the timeliness of the information needs to be addressed. The current practice is to disclose the information about the Placement Agent in the contract which falls at

the closing of the transaction. The information concerning Placement Agents would be more beneficial during the initial stages of the engagement.

In addition, KRS should review and update its Policies and Procedures to include the criteria for hiring external Investment Managers. This would give guidance for any current and future employees and help prevent situations that may give the appearance of impropriety.

III. Recommendations

- Management should update the KRS website by adding the Placement Agent Policy website.
- The Investment Staff and the Investment Committee should strive to be sensitive to the public perception of the repeated use of the same Placement Agent
- The Investment Staff should continue to maintain independence and objectivity by eliminating any actual or perceived favoritism involving Placement Agents.
- The Investment Staff should disclose any relationships and explain why the relationship exists.
- KRS should identify the involvement of placement agents or third parties during the initial engagement and presentation to the Investment Committee so that all are aware of the individuals involved in the transaction.
- All fees associated with Placement Agents should be disclosed to the Investment Committee during the initial engagement so that any Placement Agents fees can be explained.
- KRS should review and update its Policies and Procedures to include the criteria for selection of investment managers as stated in the Statement of Investment Policy.

NOTE: Mr. Sergeon has provided services to General Partners representing three (3) different business names: Diamond Edge Partners, Cazanave, and Bleeckers Street Partners. Diamond Edge Partners and Cazanave are registered with the Financial Industry Regulatory Authority (FINRA). Interviews with R.V. Kuhns and SIS indicated that this was an unusual practice. There has been no evidence discovered that would indicate improper activity concerning Mr. Sergeon's involvement with any of the above mentioned companies or partnerships.

NOTE: During the review, it was found that Mr. Sergeon made a donation to the State Employee Credit Union (SECU) Family House at University of North Carolina Hospitals in honor of the North Carolina Pension Fund Chief Investment Officer. Due to this finding, a Westlaw Review was conducted by the General Counsel to review personal records, court filings and property records of Mr. Sergeon. No record was found of any pending litigation or political contributions made on behalf of any Representatives of Kentucky.

Kentucky Retirement Systems

Placement Agent Audit Report

For the Period of July 1, 2007 – September 30, 2009

I. Purpose of the Review

The purpose of this review was to look back at the relationships Kentucky Retirement Systems (KRS) had with placement agents in order to have a better understanding of the involvement placements agents have when hiring external managers for our asset classes.

II. Scope of the Review

The review included an examination of the following:

- Placement Agent Policy
- Kentucky Retirement Systems' Investment Policy
- Northern Trust Rate of Return Report dated 9/30/09
- Private Equity Investment Quarterly Report dated 9/30/09
- Interview with Director of Alternative Investments
- Interview with Chief Investment Officer
- Confirmation Letters from Investments Managers and General Partners
- Teleconference with R.V. Kuhn's to understand the use of Placement Agents in hiring Investment Managers
- Teleconference with Strategic Investment Solutions (S.I.S.) to understand the use of Placement Agents in hiring Investment Managers
- Interview with Mr. Glen Sergeon to understand his relationship with KRS.

The review consisted of an extensive examination of various documents, investment policy, Placement Agent policy, confirmation from Investment Managers/General Partners, interviews with Investment Staff, interviews with outside consultants and an interview with a Placement Agent. The review focused primarily on the use of Placement Agents in the hiring of External Investment Managers. This examination was

conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*, as published by the Institute of Internal Auditors.

The scope of the review covered Investment Managers and/or General Partners hired between July 1, 2005 and September 30, 2009.

III. Findings and Recommendations

Finding 1. Section IV, Part B of the Placement Agent Policy states that KRS is responsible for, "providing the public with disclosure by posting a copy of this Policy on KRS' website". There is no copy of the Placement Agent Policy on the website as stated by the policy.

Recommendation

Management should update the KRS website by adding the Placement Agent Policy.

Finding 2. There was an increase in the use of Placement Agents over the last two years. KRS is working to diversify its portfolio and increase its returns by focusing on the expansion of Alternative Investments. Investments in private equity are unique investments which frequently involve a Placement Agent. (Appendix B)

Recommendation

No Recommendation.

Management has received Investment Committee approval to strategically plan and diversify the portfolios through the expansion of the Alternative Asset Class. An interview with both the Chief Investment Officer (CIO) and the Director of Alternative Assets indicated that the increase in the use of Placement Agents is due to the strategy to increase investment returns through the expansion of Alternative Investments. Since, Private Equities are typically not publicly traded, Placement Agents are often times involved with the acquisition of these Alternative Investments.

Finding 3. There was one Placement Agent (Glen Sergeon) who frequently represented General Partners doing business with KRS throughout the previous two years. In an interview with Mr. Sergeon, he made known that the Chief Investment Officer and he worked together on a global emerging market strategy when the Chief Investment Officer was employed with the Public Employers of Pennsylvania. Due to this prior working relationship and the continuous use of Mr. Sergeon, there could be a perceived appearance of preferential treatment. (Appendix B)

It should be noted that 502 KAR 5:020. Code of Ethics, Section 3: Conflict of Interests (2) General obligations of an officer. "An officer shall: (a) Avoid the appearance that preferential treatment is being given to a person or entity".

Recommendation

The Placement Agent Policy does not address how frequently a Placement Agent can be used; however, the Investment Staff and Investment Committee should strive to be sensitive to the public perception of the frequent use of one Placement Agent. The Investment Staff should continue to maintain independence and objectivity by eliminating any actual or perceived favoritism involving Placement Agents. The Investment Staff should disclose and explain any relationships with Placement Agents. Although, the investment staff should be concerned about the public perception they must also be prudent and ensure that the investment selections are based on the quality of the investment and in the best interest of the Stakeholders.

Finding 4. One discrepancy was noted in the reporting of the Placement Agent used with the Vista Equity Investment. Vista Equity reported using the Agent Marvin Rosen with Diamond Edge Capital Partners; however, the interview with the Director of Alternative Assets and the interview with Glen Sergeon revealed that Mr. Sergeon was the Agent representing Diamond Edge Capital Partners. Although, Vista Equity Investments states that Marvin Rosen was the Placement Agent representing Diamond Edge Capital Partner, we know of no direct connection he may have had with KRS.

Recommendation

No Recommendation.

The new Placement Agent Policy should resolve this kind of discrepancy. The Investment Staff should consider developing a questionnaire or some mechanism for acquiring information pertaining to Placement Agents during the due diligence phase. This would allow for information to be received in a timely manner and allow the information to be included in the initial review of the potential investment manager. (NOTE: See Appendix A for an Example of a Questionnaire used by Teachers Retirement of Texas.)

Finding 5. The Placement Agent fee paid to Camelot Acquisitions Secondary Opportunities Group, LLC was higher than the average 1-2%. The Agent was paid 3% of the amount invested. The Chief Investment Officer was unaware of the fees charged by the Placement Agent and could not explain the higher fee. The Director of Alternative Assets believed the fee was high because the fund was new and unusual in nature. Mr. Sergeon stated that the fees are a direct result of the time involved with the sale. Strategic Investment Solutions (S.I.S.) stated that any Placement Agent fee over 2% would be considered unusual.

It should be noted that Government Finance Officers Associations (GFOA) Best Practice: "Public Employee Retirement System Investments (1993, 1995, 1997, and 2009) (CORBA – Committee on Retirement and Benefit Administration) Recommendation: GFOA recommends that fiduciaries adhere to the following best practices regarding investments: 4. To maintain their fiduciary obligations, fiduciaries should carefully review investment-related practices that could be questioned (soft-dollar services, brokerage-related or broker-compensated services and unconventional investment strategies). Fiduciaries need to be especially careful about transactions that involve placement agents (agents a plan hires to find investors), ensuring that the finders' fees paid to these agents are appropriate".

Recommendation

KRS has no control over the fees paid to the Placement Agent. Placement Agent fees are defined by the contract between the Placement Agent and General Partner/Investment Manager. Although, KRS does not directly pay Placement Agents, all Placement Agent fees should be disclosed during the initial engagement so that the Investment Committee is aware of all fees associated with the transaction. Despite the finding, there was no evidence discovered that would indicate impropriety in this acquisition.

Finding 6. Statement of Investment Policy states "Relevant criteria for the selection of investment managers are contained in the Transaction Procedures statement". The Investment Transaction Procedures Policy does not contain the criteria as stated in the Statement of Investment Policy.

GFOA Best Practice on Public Employee Post-Retirement Benefits Systems (2010) (CORBA) Recommendation 3) Governance Policies: d) "Professional and Contractual Services – The board must have policies and procedures for selecting agents such as actuaries, attorneys, auditors, and fund managers. These policies and procedures must encourage an open process free of actual or perceived bias and conflict of interest".

Recommendation

Investment Policies and Procedures should be reviewed and updated to include criteria for manager selection as stated by the Statement of Investment Policy. Investment Staff should look to Financial Industry Regulatory Authority (FINRA) and Securities and Exchange Commission (SEC) to ensure the required criteria for hiring outside managers is utilized.

Conclusion

Over the past few years, KRS has sought to diversify the KRS Portfolio by focusing on the Alternative Asset Class. The increased activity within the Alternative Portfolio has resulted in an increase in the involvement of placement agents. Private Equity Investments are typically not publicly traded and often times require the use of Placement Agents in the hiring of new Investment Managers/General Partners. There has been one placement agent who has been involved more frequently than others. The frequent use of one Placement Agent gives the appearance of preferential treatment; however, based upon the audit test performed, no evidence was discovered that would indicate impropriety.

KRS has been proactive in developing a Placement Agent Policy; however, the timeliness of the information needs to be addressed. The current practice is to disclose the information about the Placement Agent in the contract which falls at the closing of the transaction. The information concerning Placement Agents would be more beneficial during the initial stages of the engagement.

In addition, KRS should review and update its Policies and Procedures to include the criteria for hiring external Investment Managers. This would give guidance for any current and future employees and help prevent situations that may give the appearance of impropriety.

NOTE: Mr. Sergeon has provided services to General Partners representing three (3) different business names: Diamond Edge Partners, Cazanave, and Bleeckers Street Partners. Diamond Edge Partners and Cazanave are registered with the Financial Industry Regulatory Authority (FINRA). Interviews with R.V. Kuhns and SIS indicated that this was an unusual practice. There appears to be no evidence of improper activity concerning Mr. Sergeon's involvement with any of the above mentioned companies or partnerships.

NOTE: During the review, it was found that Mr. Sergeon made a donation to the State Employee Credit Union Family House at University of North Carolina Hospital in honor of the North Carolina Pension Fund Chief Investment Officer. Due to this finding, a Westlaw Review was conducted by the General Counsel to review personal records, court filings and property records of Mr. Sergeon. No record was found of any pending litigation or political contributions made on behalf of any Representatives of Kentucky.

APPENDIX A

Example of Questionnaire

Appendix A – Questionnaire

to Addendum to the Teacher Retirement System of Texas Investment Policy Statement

Political Contributions; Improper Influence; Placement Agents and Finders

Capitalized terms are defined in main text of policy.

A) **Contacts with State Officials; Political Contributions.** Has any person lobbied, communicated with, or made political contributions during the past three years on behalf of the Fund or Manager Party to a Texas Elected Official in connection with a prospective investment transaction with a Texas state investment entity, including TRS?

1) If the answer is "yes," please provide a complete list of the name(s) of the entities and individual(s) involved, the approximate dates of the contributions, the amounts of the contributions, a summary of the contacts or communications, and the nature of the discussion in regards to the investment with any Texas state investment entity, including TRS.

B) **Contacts with TRS Board Members.** Has any person lobbied or otherwise communicated on behalf of the Fund or Manager Party with a current or former member of the TRS Board of Trustees during the past two years for the purpose of asking the current or former member to seek to influence a decision by the TRS investment staff or a TRS advisor or consultant to recommend that TRS invest?

1) If the answer is "yes," please provide a complete listing of the name(s) of the entities and individual(s) involved, the approximate dates of the contacts or communications, and the nature of the discussion in regards to this investment.

C) **Placement Agents and Placement Fees.** Is or was the Fund or Manager Party a party to any agreement or arrangement (whether oral or written) to pay a Placement Fee to or for the benefit of any Placement Agent in connection with TRS's prospective investment in a fund or engagement of an external manager?

1) If the answer to C) is "yes," please provide a copy of the written agreement or agreements creating the obligation to pay a Placement Fee. If the agreement is not written, please provide a written summary of the agreement. Additionally, please state the amount of the Placement Fee (or the formula for its determination if the amount is not yet determined) and the date of its payment or anticipated payment.

2) If the answer is "yes," please list the name(s) of the person or entity. If the party to the agreement is an entity, please also list the names of the principal owners, officers, directors, or managing members of the Placement Agent and provide a resume for each such person.

3) If the answer is "yes," state whether the Placement Agent, or any of its Affiliates, is registered as a lobbyist with any state government or the federal government and identify the registrants and the applicable jurisdictions where registered.

4) Will or did any TRS Person or any Relative of a TRS Person receive, has any such person received, or might any such person receive, any compensation or payment, directly or indirectly, of a commission, finder's fee, or any other consideration or benefit to be paid to a Placement Agent (a "Placement Fee") in connection with TRS's investment? If the answer is "yes," please list the name or names of the TRS Person or Relative of a TRS Person and provide details about the terms of the Placement Fee.

5) Will or did any Texas Elected Official or a Relative of a Texas Elected Official receive a Placement Fee in connection with TRS's investment? If the answer is "yes," please list the name or names of the official and provide details about the terms of the Placement Fee, including the amounts and timing of payments.

6) Did (or will) any third party person or entity who is not employed or otherwise affiliated with a Placement Agent, including a current or former TRS Person, either (a) recommend the Placement Agent or (b) receive a share of a Placement fee or any other economic benefit in connection with TRS's investment, whether directly or indirectly through a Placement Agent engaged by you?

7) If the answer to 6) is "yes," please list the name of the person or entity, the relationship of the person or entity to the Placement Agent and your firm, and provide a description of the arrangement and the reason for the payment.

8) State whether the Placement Agent or any of its Affiliates is registered with the Securities and Exchange Commission or the Financial Industry Regulatory Association, or a similar agency outside the United States. Provide details about registration or explain why registration is not required.

The undersigned certifies, represents and warrants on behalf of the Fund or Manager Party that, to the best of its knowledge after due inquiry, (a) the foregoing responses to this questionnaire are true and correct and do not omit any statement or fact necessary to make any statement made not misleading in any material respect, and (b) no prior statements or representations, if any, whether oral or written, made on behalf of the Fund or Manager Party relating to the subject matter of this questionnaire in connection with TRS's due diligence inquiries and a prospective investment management agreement or subscription to the fund, as the case may be, including any side letter agreements, was untrue or misleading in any material respect when they were made.

[signature block for Fund or Manager Party]

Attachment: Exhibit A, TRS Persons

APPENDIX B

Listing of Managers Hired July 1, 2004 through September 30, 2009

Manager Hired 7/1/2004 through 7/31/09

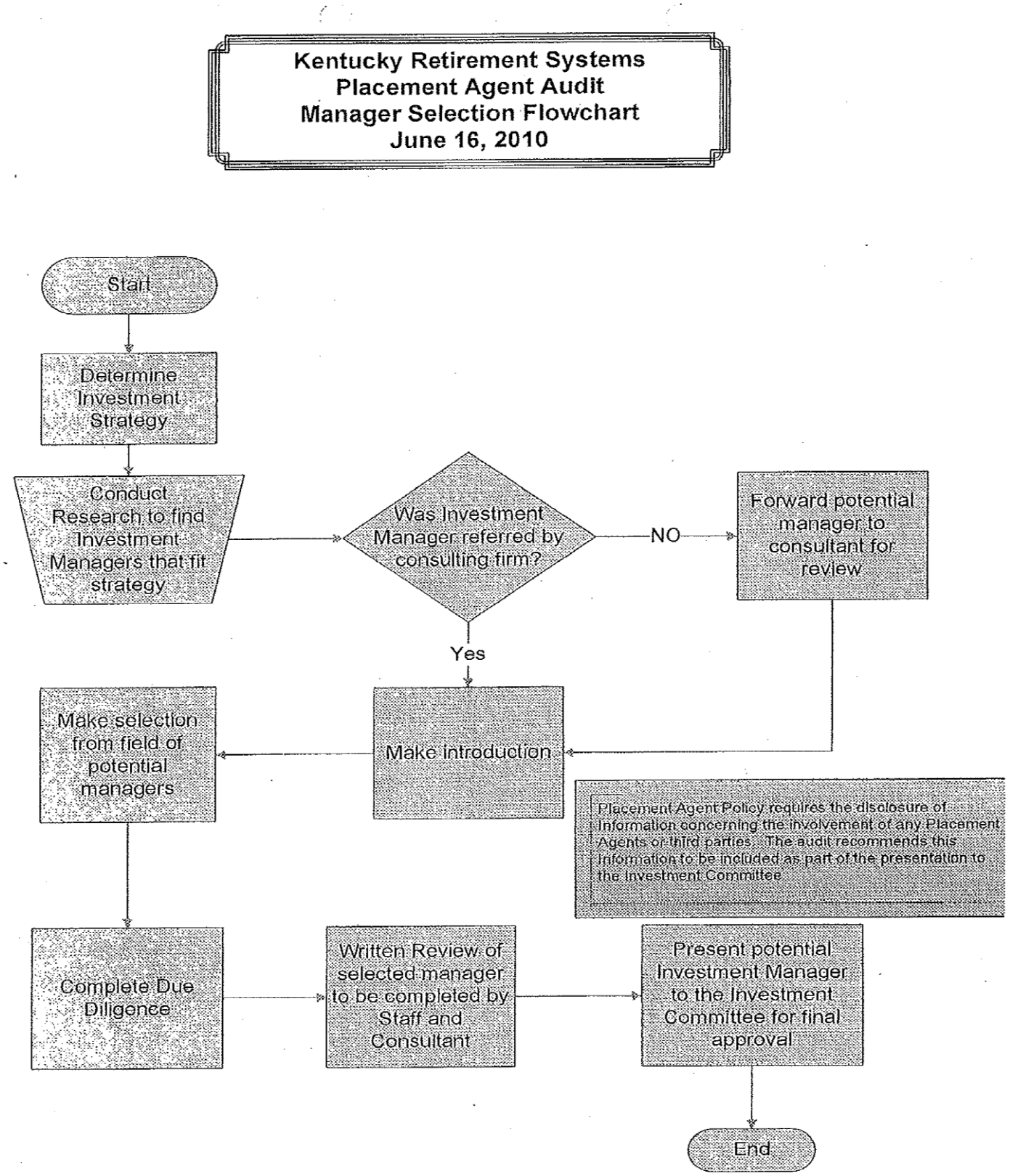
Fund	Inception	KRS Commitment	Placement Agent	Amt paid to PA	
MatlinPatterson II	1/31/2004	$ 50,000,000.00	-	$ -	
IVP XI	11/30/2004	$ 15,000,000.00	Probita Partner - Craig Marmer	$ 2,099,000.00	Payment for entire fund?
HIG Venture II	1/31/2005	$ 20,000,000.00	-	$ -	
Merit Capital	1/31/2005	$ 30,000,000.00	-		
New Mountain II	1/31/2005	$ 50,000,000.00	Credit Suisse - Robertshaw,Sullivan, Claster	$ 169,114.00	0.34%
BGI Alpha Tilts	4/30/2005		-	$ -	
Boston Company	4/30/2005		-	$ -	
Oak Hill Capital II	5/31/2005	$ 75,000,000.00	Credit Suisse - Tom Donovan	$ 622,500.00	0.83%
Warburg Pincus IX	5/31/2005	$ 100,000,000.00	-	$ -	
Columbia Capital	11/30/2005	$ 30,000,000.00	-		
Wayzata I	11/30/2005	$ 75,000,000.00	Park Hill - Roberts, Prendergrast, Keene		
Blackstone V	1/31/2006	$ 125,000,000.00	Park Hill - Dan Prendergast & Sean Keene	$ 1,250,000.00	1.00%
TCV VI	2/28/2006	$ 25,000,000.00	-	$ -	
VantagePoint 2006	2/28/2006	$ 30,000,000.00	-	$ -	
DAG II	3/31/2006	$ 30,000,000.00	BTIG - John D Lowenberg, Jr	$ 600,000.00	2.00%
MHR III	9/30/2006	$ 40,000,000.00	Credit Suisse - Cosman, Robertshaw, Bowe		
Arbor Invst. II	11/30/2005	$ 25,000,000.00	-	$ -	
GTCR IX	11/30/2006	$ 70,000,000.00	-		
Baird Core	12/31/2005		-	$ -	
Harvest Partners V	12/31/2006	$ 40,000,000.00	-	$ -	
Pyramis Core	12/31/2006		-	$ -	
DAG III	4/10/2007	$ 30,000,000.00	-		
Hellman & Friedman	5/31/2007	$ 75,000,000.00	-	$ -	
Avenue V	6/30/2007	$ 100,000,000.00	-	$ -	
Bay Hills Capital	11/30/2007	$ 75,000,000.00	-	$ -	
IVP XII	2007	$ 30,000,000.00	-	$ -	
MatlinPatterson III	2007	$ 50,000,000.00	-	$ -	
New Mountain III	2007	$ 75,000,000.00	Credit Suisse - Robertshaw,Sullivan, Claster	$ 135,000.00	0.18%
Oak Hill Capital III	2007	$ 125,000,000.00	Credit Suisse - Tom Donovan	$ 287,500.00	0.23%
Warburg Pincus X	2007	$ 75,000,000.00	-	$ -	
Wayzata II	2007	$ 75,000,000.00	Park Hill - Roberts, Prendergrast, Keene		
Mill Road Capital	1/31/2008	$ 30,000,000.00	Triago LLC - Monica Holec	$ 600,000.00	2.00%
Aberdeen	3/31/2008		-	$ -	
Wellington	3/31/2008		-	$ -	
Essex Woodlands VIII	4/30/2008	$ 50,000,000.00	Denning & Company	*See Below	
Vista Equity Partners III	4/30/2008	$ 50,000,000.00	Diamond Edge Capital Partners - Marvin Rosen\Glen Sergeon	$ 750,000.00	1.50%
Oaktree VIIB	5/31/2008	$ 75,000,000.00	-	$ -	
Sun Capital IV	5/31/2008	$ 20,000,000.00	Waiting on Response		
Blackstone VI	7/31/2008	$ 100,000,000.00	Park Hill - Thomas Roberts & Sean Keene	$ 1,000,000.00	1.00%
Crestview Partners II	9/30/2008	$ 75,000,000.00	Diamond Edge Capital Partners - Glen Sergeon	$ 1,100,000.00	1.47%
Tenaska Power Fund II	9/30/2008	$ 50,000,000.00	Lehman Brothers\Greenhill & Co	$ 218,988.00	0.44%
DAG IV	2008	$ 100,000,000.00	-		

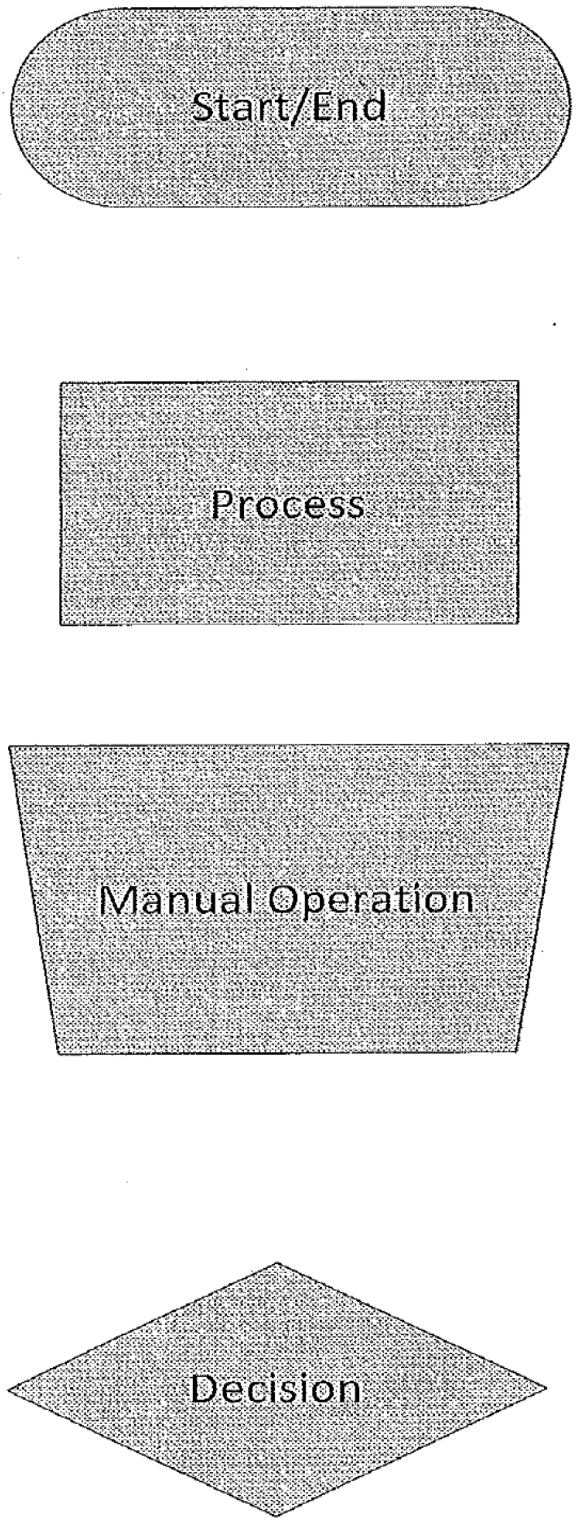
NTGI Intl Small Cap	2008		-					
VantagePoint IV	2008	$ 40,000,000.00	-		$	-		
NISA Investment Advisor	1/31/2009		-		$	-		
Bay Hills Capital II	3/31/2009	$ 50,000,000.00	-		$	-		
Commerce Street Income Part LP	4/30/2009		Cazenave & Company - Glen Sergeon \Potomac Capital		$	706,250.00		
Horsley Bridge Int'l V	4/30/2009	$ 50,000,000.00	Bleecker Street Partners - Glen Sergeon		$	437,550.00	0.88%	
Prima Mortgage	4/30/2009		-		$	-		
Tortoise Capital Advisors	4/30/2009	$ 25,000,000.00	Atlantic Asset Mtg - Rick Volp\Bleecker Street Partners - Glen Sergeon		% of Advisory Fee			
Walton Street Real Estate	4/30/2009		-					
Artio Global Intl Equity II	7/31/2009		-		$	-		
Arrowhawk	11/30/2009	$ 200,000,000.00	Bleecker Street Partners - Glen Sergeon		$	2,040,000.00	1.02%	
Camelot Opportunities	2009	$ 26,000,000.00	Bleecker Street Partners - Glen Sergeon		$	780,000.00	3.00%	

*Paid a Flat Fee which was in to way allocalbe to KRS.

APPENDIX C

Manager Selection Flowchart


Kentucky Retirement Systems
Placement Agent Audit
Manager Selection Flowchart
June 16, 2010
Start
Determine Investment Strategy
Conduct Research to find Investment Managers that fit strategy
Was Investment Manager referred by consulting firm?
NO
Forward potential manager to consultant for review
Yes
Make introduction
Make selection from field of potential managers
Placement Agent Policy requires the disclosure of information concerning the involvement of any Placement Agents or third parties. The audit recommends this information to be included as part of the presentation to the Investment Committee.
Complete Due Diligence
Written Review of selected manager to be completed by Staff and Consultant
Present potential Investment Manager to the Investment Committee for final approval
End


Start/End
Process
Manual Operation
Decision

APPENDIX D

Audit Report Response

KENTUCKY RETIREMENT SYSTEMS
Investments

To:	Connie A. Davis, CIA Internal Auditor	Ann M. Case Compliance Officer
From:	Adam C. Tosh, CFA Chief Investment Officer	
Date:	July 16, 2010	
Subject:	**Response: Placement Agent Audit of July 14, 2010**	

In light of the major scandal in the second quarter of 2009, surrounding several elected officials, trustees, officers, and placement agents at the New York State Common Retirement Fund and at the City of New York's pension fund, the Kentucky Retirement Systems sought to be proactive with regard to strengthening its policies and practices relating to third-party marketers, lobbyists, and placement agents. In August 2009, the Board of Trustees approved the Placement Agent Statement of Disclosure Policy which had been prepared by the Investment and Legal staff working with our independent consultants. In addition, even before the adoption of this policy, we began requiring disclosure of any placement agent involvement, Board contact, or contribution within KRS' deal documents.

The goals of KRS' Placement Agent Statement of Disclosure Policy and practices have been to bring transparency to placement agent activity in connection with KRS' investments and help ensure that KRS' investment decisions adhere to "best practices" and are made solely on the merits of the investment opportunity and in a manner consistent with the responsibilities of the Board of Trustees and individuals who owe a fiduciary duty to KRS.

Consistent with this Policy and in order to instill confidence in KRS' investment decisions and process, KRS Staff recommended this audit and generally concur with the recommendations of this Placement Agent Audit performed.

Recommendation 1.

Management should update the KRS website by adding the Placement Agent Policy.

Response 1.

We concur with recommendation one. The Placement Agent Statement of Disclosure is intended to bring transparency to placement agent activity in connection with KRS' investments and help ensure that KRS' investment decisions are made solely on the merits of the investment opportunity and in a manner that is consistent with the responsibilities of the Board of Trustees' and individuals who owe a fiduciary duty to KRS.

The KRS Board approved the Private Placement Statement of Disclosure. It requires that KRS Staff shall be responsible for posting a copy of the Policy on KRS' website (see Placement Agent Statement of Disclosure, IV. Responsibilities: Section B.).

B. KRS Staff is responsible for the following:

- *Providing the public with disclosure by posting a copy of this Policy on KRS' website.*
- *Implementing this Policy for KRS.*

All parties responsible for implementing, monitoring and complying with this Policy shall consider the spirit as well as the literal expression of the Policy.

Recommendation 2.

No Recommendation.

Management has received Investment Committee approval to strategically plan and diversify the portfolios through the expansion of the Alternative Asset Class. An interview with both the Chief Investment Officer (CIO) and the Director of Alternative Assets indicated that the increase in the use of Placement Agents is due to the strategy to increase investment returns through the expansion of Alternative Investments. Since, Private Equities are typically not publicly traded, Placement Agents are often times involved with the acquisition of these Alternative Investments.

Response 2.

The Kentucky Retirement Systems strives to access tomorrow's business before the broader marketplace claims all the excess value. The expected returns we seek from private equity are considerably larger than would be realized from mature fully formed publicly traded corporations.

KRS has a demonstrated interest in finding the best expected performing managers to populate the portfolios. KRS has often sought out small and medium size managers to capture market inefficiencies and highly entrepreneurial funds with unique strategies that have the potential to return oversized profits. We seek to find the most appropriate investment manager, fund, and strategy available to achieve our investment objectives. Finding these types of funds may become more difficult without the fund introductions made by and the ability to meet with third-party marketers (placement agents) who disseminate fund marketing materials and information.

As a result of the nature and immaturity of the underlying businesses within private equity/alternative investments, many of the non-core activities of these businesses are outsourced to specialty vendors – legal services, accounting, audit services, and sales and marketing services are routinely performed by experts external to the business, such as placement agents.

The role and function of the placement agents is to provide marketing services to alternative and private equity firms/funds that invest in these underlying companies; often through the preparation of marketing/sales materials and the introduction and dissemination of the fund's strategy and information to potential institutional investors. Placement agents exist because, with the exception of the largest private equity general partnerships (GP's), most issuers of private equity (and other asset classes) are not equipped to raise their investment funds independently. They do not have the resources internally to access the capital markets. They require services like crafting presentations, drafting, proofing and

distributing private placement memorandums, sorting the potential universe of limited partners and determining how to access those limited partners, arranging meetings with the limited partners, handling follow ups to the meetings, assisting in the due diligence process including managing on site due diligence meetings, and the closing process.

KRS seeks to do business with experienced, reputable, and SEC registered investment organizations (including placement agents) and utilizes a due diligence process designed to screen and select firms expected to best achieve KRS' investment objectives. Placement agents, registered lobbyists, and third-party marketers are encountered by KRS in the normal course of day-to-day business. Third-party marketers are commonly used by various investment organizations to locate and market to potential investors. KRS does not hire or pay for third-party, placement, or investment lobbying fees. If a third-party marketer is utilized by an investment organization, their fees are paid by only the investment firm. KRS does not pay finder's fees.

With only KRS' limited ability to source new deal flow, KRS' exposure in private equity in particular would likely gravitate to larger funds with in-house marketing capability and increase the need for KRS Staff to travel. Additionally, a greater concentration and reliance on larger funds would increase KRS' business risk and diminish our ability to be a significant investor in order to structure more favorable financial and business terms for KRS, as well as potentially reduce KRS' expected returns. Furthermore, it may adversely affect our ability to influence investment decisions, participate on investment advisory boards, and have a voice in the management of the firms would likely be nearly non-existent, as larger funds would dominate.

Recommendation 3.

The Placement Agent Policy does not address how frequently a Placement Agent can be used; however, the Investment Staff and Investment Committee should strive to be sensitive to the public perception of the frequent use of one Placement Agent. The Investment Staff should continue to maintain independence and objectivity by eliminating any actual or perceived favoritism involving Placement Agents. The Investment Staff should disclose and explain any relationships with Placement Agents. Although, the investment staff should be concerned about the public perception they must also be prudent and ensure that the Investment selections are based on the quality of the investment and in the best interest of the Stakeholders.

Response 3.

We concur that the Investment Staff and Investment Committee should strive to be sensitive to public perception and continue to maintain independence and objectivity by eliminating actual or perceived favoritism. The Placement Agent Statement of Disclosure is designed to improve transparency and we agree with the disclosure and explanation of any relationship(s) with Placement Agents.

However, the Placement Agent Statement of Disclosure does not specifically address the frequency that a placement agent may be used because KRS does not determine which

investments to participate in based on placement agent/salespeople criteria. The employment and marketing utilization of placement agents is determined solely by the alternative and private equity firms/funds and is outside of the control of KRS. KRS does not solicit, employ, or pay placement agent fees.

Furthermore, we are in complete agreement that the investment staff should be concerned about public perception and that Investment Committee and Staff must also be prudent and ensure that the investment selections are based on the quality of the investment and in the best interest of the Stakeholders.

Recommendation 4.

No Recommendation.

The new Placement Agent Policy should resolve this kind of discrepancy. The Investment Staff should consider developing a questionnaire or some mechanism for acquiring information pertaining to Placement Agents during the due diligence phase. This would allow for information to be received in a timely manner and allow the information to be included in the initial review of the potential investment manager. (NOTE: See Appendix A for an Example of a Questionnaire used by Teachers Retirement of Texas.)

Response 4.

The Investment Office agrees that KRS should further develop a questionnaire or other framework to acquire information pertaining to placement agents during the due diligence process. The approved Private Placement Statement of Disclosure Policy outlines the general questions and responsibility of the external managers KRS is seeking to hire (see Placement Agent Statement of Disclosure, IV. Responsibilities, Section A.).

IV. Responsibilities:

A. Each of KRS' External Manager(s) is responsible for:

Prior to KRS investing with any manager, KRS Staff shall obtain a written representation from the investment manager, in a form acceptable to KRS' Legal Office, stating that the investment manager has not used a placement agent in connection with the KRS investment opportunity, or if the manager has used a placement agent, it will disclose the following to KRS:

- *the name of the placement agent.*
- *the fee paid or payable to the placement agent.*
- *representation that the fee is the sole obligation of the investment manager and not that of KRS or the limited partnership.*

- *current or former Kentucky Officials (federal, state, and local government), KRS Board of Trustees members, employees, or Consultants KRS board members, employees, or consultants that are either employed or receiving compensation from the placement agent.*
- *the names of any current or former Kentucky Officials (federal, state, and local government) KRS Board of Trustees members, employees, or consultants who suggested the retention of the placement agent.*
- *the regulatory agencies the placement agent or any of its affiliates are registered with, such as the Securities and Exchange Commission ("SEC"), FINRA, or any similar regulatory agency.*
- *a resume for each officer, partner or principal of the Placement Agent detailing the person's education, professional designations, regulatory licenses and investment and work experience.*
- *a description of the services to be performed by the Placement Agent.*
- *a statement whether the Placement Agent, or any of its affiliates, is registered as a lobbyist with any and all Kentucky state and local (county) government.*
- *a statement representing and warranting the accuracy of the information included in the Placement Agent Information Disclosure in any final written agreement with a continuing obligation to update any such information within 10 business days of any change in the information.*

In the event a placement agent is expected to receive remuneration for a KRS investment, KRS Staff will notify the Investment Committee seek authorization in the memorandum discussing the recommended/approved investment. If a manager breaches the Policy, Staff will notify the Investment Committee in a timely manner.

We would further recommend that KRS' Legal Office assist in the structuring and reporting requirements that KRS is seeking within the placement agent questionnaire or other framework and that KRS' Compliance Officer be responsible for collecting the questionnaire responses and reporting/attaching this information to the Investment Memorandum prepared by the Investment Consultant and Staff which is then presented to the Investment Committee at the appropriate Investment Committee Meeting for which the investment firm/fund is being considered for approval/retention.

Recommendation 5.

KRS has no control over the fees paid to the Placement Agent. Placement Agent fees are defined by the contract between the Placement Agent and General Partner/Investment Manager. Although, KRS does not directly pay Placement Agents, all Placement Agent fees should be disclosed during the initial engagement so that the Investment Committee is aware of all fees associated with the transaction. Despite the finding, there was no evidence discovered that would indicate impropriety in this acquisition.

Response 5.

Based upon further research, it is our understanding that the initial marketing effort of a first fund is more intensive than follow–on funds. Therefore, placement agents may be able to secure a higher relative fee from the fund's general partner for the marketing and representation of their initial fund. However, since KRS does not employ placement agents nor pay their fees, any remuneration agreements are strictly between the fund's GPs/investment manager and the placement agent and are not within the scope of KRS' control. Placement agents are paid directly by the fund's general partner. The fund/investment manager determines which placement agent/third–party marketer, if any, to employ for the outsourcing of their marketing effort.

The KRS Private Placement Statement of Disclosure, approved by the Board of Trustees in August of 2009, outlines the general questions and responsibility of the external managers KRS is seeking to hire (see Placement Agent Statement of Disclosure, IV. Responsibilities, Section A.).

We concur that placement agents involved with investments in which KRS is considering should be disclosed within the investment recommendation memorandum as outlined in KRS' Placement Agent Statement of Disclosure, IV. Responsibilities, Section A. The inclusion of this disclosure within the investment memorandum should enhance the timeliness of the information and mitigate any public and/or political misperceptions (see Placement Agent Statement of Disclosure, IV. Responsibilities, Section A.).

Recommendation 6.

Investment Policies and Procedures should be reviewed and updated to include criteria for manager selection as stated by the Statement of Investment Policy. Investment Staff should look to Financial Industry Regulatory Authority (FINRA) and Securities and Exchange Commission (SEC) to ensure the required criteria for hiring outside managers is utilized.

Response 6.

We concur with recommendation 6. The Investment Policies and Procedures are and should continue to be reviewed and updated on an annual basis. The Investment Office agrees that language clarifying the existing criteria for manager selection, as outlined in the Investment Transaction Procedures Policy, could further enhance KRS' selection process and diminish any potential public and/or political misperceptions. Certainly, incorporating regulations from the Financial Industry Regulatory Authority (FINRA) and the United States Securities and Exchange Commission (SEC) will further enhance KRS' manager selection procedures and policies.

Timeline of Significant Events Prior to and During the Examination by the Auditor of Public Accounts

Exhibit 2

Date	Event
June 24, 2010	CIO resigns at special meeting of the KRS Investment Committee but continues to work through July 16, 2010.
August 12, 2010	Internal audit staff submits draft of Placement Agent Audit to Investment Committee for review and comment.
August 17, 2010	Internal audit staff submits final draft of Placement Agent Audit to the KRS Audit Committee for discussion and approval. Audit Committee approves the draft report and sends it to the full KRS Board.
August 19, 2010	Placement Agent Audit report is submitted to the KRS Board. Board votes to send report back to Audit Committee for further review.
September 1, 2010	Placement Agent Audit is discussed at a special meeting of Audit Committee. In having the audit returned, the Audit Committee decides to request an audit from the APA. No further action is taken to finalize the draft report.
September 2, 2010	KRS Board Chair and KRS Executive Director meet with the APA to request an audit.
September 9, 2010	SEC makes initial documentation request to KRS.
October 5, 2010	The APA sends a letter to notify the Board Chair and Audit Committee Chair that the agency will be conducting a special examination at KRS.
November 18, 2010	SEC sends second documentation request to KRS.
November 30, 2010	KRS announces the hiring of a new CIO.
February 1, 2011	An addendum to the Transaction Policy for Limited Partnerships was approved by the Investment Committee.
March 31, 2011	OAG Open Records Decision, 11-ORD-049, found that KRS violated the Open Records Act in denying a request for "the current payroll records for Kentucky Retirement System employees."
March 31, 2011	Board Membership for a Governor Appointee expires.
April 1, 2011	Board Membership for a new Governor Appointee begins.
April 7, 2011	Trustees elect a new Board Chair and Vice Chair at the KRS Board Annual Meeting.
April 7, 2011	Board votes to terminate the employment of the KRS Executive Director and appoints the COO as the interim Executive Director.
April 12, 2011	General Counsel resigns, but continues to work through May 2, 2011. Interim General Counsel is appointed.
April 13, 2011	New KRS Board Chair announces the new committee leadership and assignments.

Source: Auditor of Public Accounts based on information provided by the Kentucky Retirement System.

Placement Agent Internal Audit Timeline

Exhibit 3

August 8, 2009	Placement Agent Statement of Disclosure Policy approved by the KRS Investment Committee, signed by Chair.
August 20, 2009	Placement Agent Statement of Disclosure Policy Disclosure policy approved by the KRS Board, signed by Chair.
August 20, 2009	Discussion at KRS Board meeting concerning the "pay-to-play" issue related to placement agents led by KRS General Counsel.
September 29, 2009	An investment made by KRS involved a placement agent but did not comply with the newly adopted Placement Agent Statement of Disclosure Policy.
October 30, 2009	Email correspondence indicates that a "pay-to-play" placement agent audit was requested during a meeting between the KRS Executive Director and Director of Internal Audit.
November 24, 2009	Internal Audit Compliance Officer sends draft of audit program to the Director of Internal Audit.
December 1, 2009	Letter sent by KRS Internal Audit Compliance Officer to KRS investment managers requesting information on the use of placement agents and any fees paid.
December 9, 2009	Email from a KRS Board Trustee to Chair of Investment Committee stating he had heard a particular placement agent was involved in five or six "hires at KRS" of investment managers and that, if true, this should be disclosed according to policy.
December 10, 2009	Email from the KRS Executive Director responding to the Chair of Investment Committee regarding the December 9, 2009 email from the Board Trustee. The email states that the placement agent and his fee were disclosed in the most recent investment contract with KRS and a copy of the contract was attached.
January 15, 2010	Date of memorandum from Internal Audit Compliance Officer to the Director of Internal Audit and the Chair of the Investment Committee concerning the "pay-to-play" audit scope and status. Memo included names of placement agents used by KRS investment managers. Memo notes not all information available at that time. This memo was included in the packet of information sent to the Investment and Audit Committee members.
February 2, 2010	Internal Audit Compliance Officer informed the Investment Committee members of the current investment related audits being conducted.
February 4, 2010	Internal Audit Compliance Officer presents January 15, 2010 memo to the Audit Committee and notes the scope of the audit is to review the use of placement agents and that the report should be ready by the May 2010 Audit Committee meeting. This memo listed the names of the placement agents associated with the KRS investments.
February 12, 2010	Email from KRS General Counsel to the Executive Director suggesting that the internal auditors follow up on the relationship of "investment department" with a certain placement agent due to frequent involvement in investments and the amounts paid by investment managers.

February 26, 2010	Email from KRS former CIO to the Executive Director, General Counsel, and Chair of the Investment Committee stating that, in light of the placement agent audit, he wanted to inform them that a certain placement agent would be representing a prospective investment manager.
February 26, 2010	Final placement agent fee information was provided by investment managers to internal auditors.
March 11, 2010	Internal auditors, Executive Director, and General Counsel interview KRS general investment consultant.
April 13, 2010	Email from KRS Executive Director to the General Counsel asking about the schedule of audit interviews. He stated that he would like the Audit Committee to get the final report at the May meeting.
April 15, 2010	Internal auditors, Executive Director, and General Counsel interview KRS alternative asset investment consultant.
April 16, 2010	Director of Internal Audit emails Executive Director to question why General Counsel included the Chief Investment Officer on the invitation to interview a placement agent. The General Counsel states the Chief Investment Officer was included for informational purposes only and was not intended for the Chief Investment Officer to be present in the interview.
April 26, 2010	Internal auditors, Executive Director, and General Counsel interview placement agent involved in seven KRS investments.
April 27, 2010	Internal Audit Compliance Officer interviews the Chief Investment Officer.
April 27, 2010	Internal Audit Compliance Officer interviews the Director of Alternative Investments.
April 30, 2010	Director of Internal Audit sends email to Executive Director and General Counsel requesting meeting to discuss unspecified issues regarding placement agents. Also asked about the inclusion of the Placement Agent Audit on the agenda of the May Audit Committee meeting.
May 4, 2010	The Chairs of the Investment and Audit Committees were privately informed of the audit findings after the Investment Committee meeting was adjourned.
May 14, 2010	Email from a Board Trustee to the Director of Internal Audit again stating he has heard a placement agent was involved in five or six KRS investments. Director of Internal Audit responds that the Placement Agent Audit will give a complete accounting of all placement agents used and, in performing this audit, the internal auditors became aware of this placement agent.
June 8, 2010	Email to General Counsel from the Internal Audit Compliance Officer requesting a meeting concerning completed placement agent audit findings. Executive Director not included in email.
June 24, 2010	Chief Investment Officer resigns at special meeting of Investment Committee.

Placement Agent Internal Audit Timeline

Exhibit 3

July 12, 2010	Internal auditors submit a draft report of the Placement Agent Audit to the Chief Investment Officer, Executive Director, and General Counsel for review and response.
July 16, 2010	Chief Investment Officer sends internal auditors written response to Placement Agent Audit.
August 11, 2010	The Director of Internal Audit responded to a Board Trustee by email that questions submitted on August 5, 2010 concerning the Placement Agent Audit would be answered at the Investment Committee meeting to be held on the following day.
August 12, 2010	Internal audit submitted draft of Placement Agent Audit to Investment Committee for review and comments.
August 17, 2010	Internal audit submitted final draft of Placement Agent Audit to the Audit Committee for discussion and approval. The Audit Committee approves draft report and sends to the full KRS Board.
August 19, 2010	Placement Agent Audit draft report submitted to the KRS Board. Board votes to send report draft back to Audit Committee for further review.
August 23, 2010	Email from a Board Trustee questioning why the use of placement agents was "buried" in a memo submitted at the February 2010 Audit Committee meeting and not presented to the full KRS Board.
August 23, 2010	Kentucky Governor sends a letter to the KRS Board Chair suggesting the Board request the APA conduct an independent review of the adequacy of the internal audit process and also determine if additional steps are needed.
September 1, 2010	Audit Committee meeting to discuss Placement Agent Audit. The Audit Committee votes to request an audit from the APA. No further action is taken to finalize the draft report..
September 2, 2010	KRS Board Chair and KRS Executive Director meet with the APA to request an audit.
September 9, 2010	SEC contacts the KRS by letter to notify that an informal inquiry was being conducted. The SEC sends an initial documentation request to the KRS General Counsel.
November 18, 2010	SEC sends second document request to KRS.

Management Fees and Placement Agent Activity for KRS Alternative Assets by Classification of the Investment July 1, 2004 – December 31, 2010

Exhibit 4

Manager	Commitment Date	Commitment Amount	Classification	Management Fee	Placement Agent
1	3/21/2006	$25,000,000	Buyout	2.50%	
6	7/25/2005	$125,000,000	Buyout	1.18%	Yes
6	6/16/2008	$100,000,000	Buyout	1.50%	Yes
10	8/13/2008	$75,000,000	Buyout	2.00%	Yes
14	12/19/2006	$100,000,000	Buyout	1.50%	Yes*
15	6/14/2006	$70,000,000	Buyout	1.50%	
16	1/30/2006	$40,000,000	Buyout	2.00%	Yes*
17	9/27/2006	$75,000,000	Buyout	1.50%	
26	2/5/2008	$30,000,000	Buyout	2.00%	Yes
27	1/31/2005	$50,000,000	Buyout	2.00%	Yes
27	5/8/2007	$75,000,000	Buyout	2.00%	Yes
28	4/25/2005	$75,000,000	Buyout	1.75%	Yes
28	10/10/2007	$46,250,000	Buyout	1.75%	Yes
31	4/25/2005	$20,000,000	Buyout	2.00%	
33	6/16/2008	$30,000,000	Buyout	1.50%	Yes
36	3/27/2008	$50,000,000	Buyout	2.00%	Yes
2	9/29/2009	$40,000,000	Buyout; Fund of Funds	0.60%	
5	10/10/2007	$75,000,000	Buyout; Fund of Funds	0.75%	
5	2/3/2009	$50,000,000	Buyout; Fund of Funds	0.75%	
21	11/4/2009	$40,000,000	Buyout; Fund of Funds	0.90%	
19	4/14/2009	$50,000,000	Buyout; Fund of Funds; Growth Capital; Venture Capital	0.75%	Yes
38	4/25/2005	$100,000,000	Buyout; Growth Capital; Venture Capital	1.50%	
38	10/10/2007	$75,000,000	Buyout; Growth Capital; Venture Capital	1.50%	
4	5/8/2007	$100,000,000	Debt Related	1.50%	
22	8/8/2007	$50,000,000	Debt Related	1.50%	Yes*
23	1/31/2005	$30,000,000	Debt Related	1.75%	
24	11/5/2008	$40,000,000	Debt Related	1.50%	Yes*
25	12/15/2005	$40,000,000	Debt Related	1.75%	Yes
29	4/4/2007	$75,000,000	Debt Related	1.75%	Yes*
30	11/5/2008	$40,000,000	Debt Related	.4% on NAV plus 75 bps for origination of new loans	
39	10/31/2005	$75,000,000	Debt Related	1.75%	Yes
39	11/7/2007	$75,000,000	Debt Related	1.75%	Yes
7	5/5/2009	$26,000,000	Direct Secondaries	1.50%	Yes
9	5/5/2009	$50,000,000	Fixed Income	2.00%	Yes
34	4/14/2009	$25,000,000	MLP	1.00%	Yes
3	9/29/2009	$200,000,000	Multi-Strategy	1.00%	Yes
37	11/5/2008	$40,000,000	Opportunistic/Value-Add	1.5% invested capital; 1% acquisition fee	
8	12/15/2005	$30,000,000	Venture Capital	2.00%	
11	3/31/2006	$30,000,000	Venture Capital	2.50%	Yes

Management Fees and Placement Agent Activity for KRS Alternative Assets by Classification of the Investment July 1, 2004 – December 31, 2010

Exhibit 4

Manager	Commitment Date	Commitment Amount	Classification	Management Fee	Placement Agent
11	4/4/2007	$30,000,000	Venture Capital	2.00%	
11	8/13/2008	$100,000,000	Venture Capital	2.00%	
12	9/29/2009	$15,000,000	Venture Capital	2.50%	
13	3/27/2008	$50,000,000	Venture Capital	2.00%	Yes*
18	10/25/2004	$20,000,000	Venture Capital	2.25%	
20	11/30/2004	$15,000,000	Venture Capital	Up to 2.55%	Yes
20	4/4/2007	$30,000,000	Venture Capital	Up to 2.55%	
32	10/31/2005	$25,000,000	Venture Capital	Up to 2.25%	
35	7/25/2005	$30,000,000	Venture Capital	2.00%	

Source: APA based on information provided by KRS investment staff.

*A placement agent was retained by the investment manager, but there was no placement agent contact or activity related to the KRS investment. No placement agent fees were attributed to the KRS investment.

Investment Manager Legend

Investment Manager	ID Number
Arbor Investments II	1
ArcanoKRS Fund I	2
Arrowhawk	3
Avenue Capital V	4
Bay Hills Capital	5
Bay Hills Capital II	5
Blackstone V	6
Blackstone VI	6
Camelot Opportunities	7
Columbia Capital	8
Commerce Street Income Partners LP	9
Crestview Partners II	10
DAG II	11
DAG III	11
DAG IV	11
DCM	12
Essex Woodlands VIII	13
Green Equity V	14
GTCR IX	15
Harvest Partners V	16
Hellman & Friedman VI	17
HIG Venture II	18
Horsley Bridge International V	19
IVP XI	20
IVP XII	20
Keyhaven Capital III	21
MatlinPatterson III	22
Merit Capital IV	23
Mesa West II	24
MHR III	25
Mill Road Capital	26
New Mountain II	27
New Mountain III	27
Oak Hill Capital II	28
Oak Hill Capital III	28
Oak Tree VIIB	29
Prima Mortgage Investment Trust	30
Sun Capital IV	31
TCV VI	32
Tenaska Power Fund II	33
Tortoise Capital Advisors	34
VantagePoint 2006	35
Vista Equity Partners III	36
Walton Street Real Estate VI	37
Warburg Pincus IX	38
Warburg Pincus X	38
Wayzata I	39
Wayzata II	39

Source: Auditor of Public Accounts

Placement Agent Legend

Placement Agent	ID Letter
Credit Suisse	A
Park Hill Group	B
Diamond Edge Capital Partners	C
Probitas Partner	D
BTIG, LLC	E
Triago, LLC	F
Lehman Brothers, Inc	G
Greenhill &Co.	H
Potomac Capital Markets	I
Cazenave & Co.	J
Bleeker Street Partners	K

Source: Auditor of Public Accounts

KENTUCKY RETIREMENT SYSTEMS RESPONSE

KENTUCKY RETIREMENT SYSTEMS

William A. Thielen, Interim Executive Director

Perimeter Park West • 1260 Louisville Road • Frankfort, Kentucky 40601
kyret.ky.gov • Phone: 502-696-8800 • Fax: 502-696-8822

June 21, 2011

Honorable Crit Luallen
Auditor of Public Accounts
209 St. Clair Street
Frankfort, KY 40601-1817

Re: Report on Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems

Dear Ms. Luallen:

This letter constitutes the response of the Kentucky Retirement System (KRS) Board of Trustees to your draft report on the Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems, which was received by KRS at close of business on June 16, 2011.

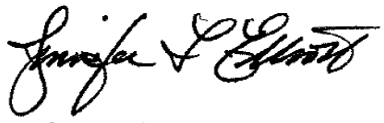
As Chair of the KRS Board of Trustees, I wish to express, on behalf of the KRS Board members and staff, our appreciation to you and your staff on the professional and thorough manner in which this examination was conducted and on the preparation of the draft examination report.

As you point out in your draft report, many changes in personnel at KRS and the KRS Board have occurred while this examination was being conducted. I can assure you as the new KRS Board Chair that I am committed to running an accountable, transparent, ethical and efficient agency, which provides the highest quality service to our members. I am also certain that the other board members and the KRS staff have the same commitment. In furtherance of our commitment to improve the agency, we have already begun the process of implementing a number of the recommendations in your report. For example, business processes have been changed in our investment division to ensure greater transmission of key decisional information to the Investment Committee. Monthly investment expense reports are being provided to our Chief Investment Officer, who will report on these expenses to the Investment Committee at its regular quarterly meetings. The KRS bylaws have been amended to add the KRS Board Chair as a media contact. Our website now contains a "Transparency" link which connects a reader to voluminous information about Kentucky Retirement Systems.

We do not disagree with any of the findings and recommendations contained in your report. To the extent we have not already done so, we will begin immediately to implement your recommendations; however, we do reserve the right to review the recommendations more thoroughly in the coming weeks and to provide more specific responses concerning any of the recommendations that present practical or legal issues related to their implementation.

In conclusion, we believe your report provides a blueprint for changes that, when implemented, will result in an improved organization that is fully accountable to its members and the public at-large and that is operated in an ethical and efficient manner.

Sincerely,



Jennifer Landrum Elliott
Chair
Kentucky Retirement System
Board of Trustees