

**EXAMINATION OF CERTAIN POLICIES, PROCEDURES,  
CONTROLS, AND TRANSPARENCY COMPLIANCE  
ACTIVITIES OF  
RETIREMENT SYSTEMS IN KENTUCKY**



**MIKE HARMON  
AUDITOR OF PUBLIC ACCOUNTS**

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August 27, 2019

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Dear Ms. Early, Mr. Eager, and Mr. Harbin:

The Auditor of Public Accounts (APA) has completed its examination of the Judicial Form Retirement System (JFRS), the Kentucky Retirement Systems (KRS), and the Teachers Retirement System of Kentucky (TRS). This report summarizes the procedures performed and communicates the results of those procedures.

The purpose of this examination was not to provide an opinion on the financial statements, but to determine each systems' compliance with specific elements of Senate Bill 2, to evaluate whether account delinquencies impacting these systems exist and agency measures taken to address such delinquencies, and to evaluate each system's process for indication of deceased beneficiaries to determine whether payments are being made on accounts of deceased individuals.

Detailed findings and recommendations based on our examination are presented in this report to assist each system in implementing corrective action. Overall, these findings indicate the following:

- KRS and TRS need to provide greater transparency of investments, particularly in relation to investment manager contracts.
- KRS needs to improve its tracking of investment manager contracts to enable accurate reporting of the number of contracts it has.
- TRS is not clearly reporting carried interest on investments to allow the public to readily identify how much investment managers are making on TRS investments.
- Additional controls may exist to assist KRS in monitoring and controlling investment fees.
- KRS has \$16.1 million in delinquent balances, and penalties are not consistently applied.
- Greater controls and oversight by KRS and JFRS are needed to avoid payments made to deceased individuals.

We appreciate your assistance and the assistance of your staff throughout the examination. If you have any questions or wish to discuss this report further, please contact me or Andrew English, Executive Director, Auditor of Public Accounts.

Sincerely,



Mike Harmon  
Auditor of Public Accounts



## **CHAPTER I: INTRODUCTION AND BACKGROUND**

### **Examination Scope**

On July 19, 2018, the Auditor of Public Accounts (APA) notified the executive officer of the Kentucky Retirement Systems (KRS) of its intent to conduct special examination procedures. On August 22, 2018, the same notification was made to the Judicial Form Retirement System (JFRS) and the Teachers Retirement System of Kentucky (TRS). The scope of the examination focused on system compliance with specific elements of the 2017 Senate Bill 2 (SB2) transparency legislation passed by the Kentucky General Assembly which became effective in 2017. In addition to examining the systems' compliance with elements of SB2, the APA examined the process followed by each system to identify deceased retirees and retirement beneficiaries, as well as collections and delinquencies. Examination procedures focused primarily on system activity in these areas occurring between the period of July 1, 2017 and June 30, 2018.

The purpose of this examination was not to provide an opinion on the financial statements or to duplicate the work of the retirement systems' annual financial statement audits. The objectives of this examination were to determine JFRS's, KRS's, and TRS's compliance with specific elements of SB2, to evaluate whether account delinquencies impacting these systems may exist and agency measures taken to address such delinquencies, and to evaluate each system's process for identification of deceased beneficiaries to determine whether payments are being made on accounts of deceased individuals.

### **Judicial Form Retirement System**

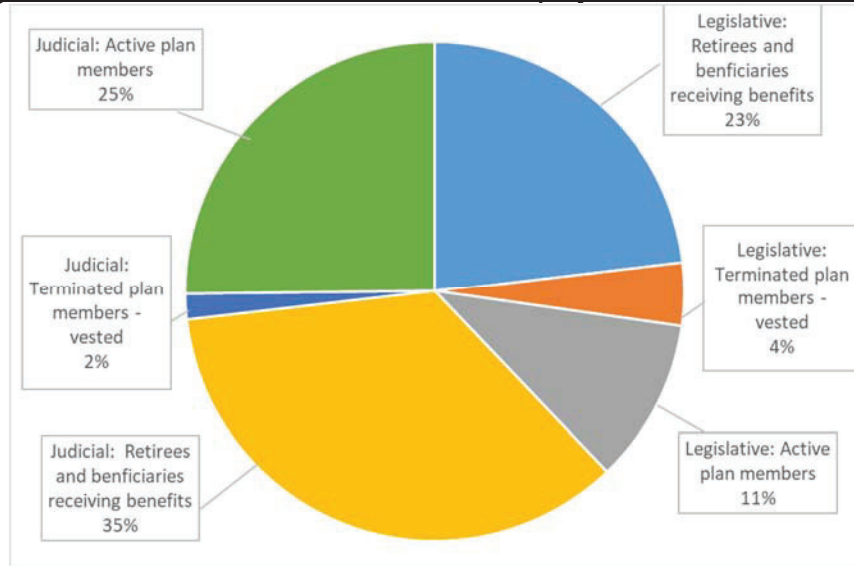
The Judicial Form Retirement System (JFRS) is a state agency responsible for the administration of the Judicial Retirement Plan and the Legislative Retirement Plan. The system is governed by a Board of Trustees, which consists of eight members, three appointed by the Supreme Court, two by the Governor, one by the Senate President, one by the Speaker of the House and one jointly by the President and Speaker. The daily operations of JFRS and its plans are managed by an Executive Director, who is employed by the Board of Trustees.

Per Kentucky Revised Statute 21.550 and Kentucky Revised Statute 21.560, each plan, Judicial and Legislative, has its own Investment Committee that is designated by Kentucky state law to have full and sole authority over each fund and the investments. The investment committees can arrange for both the funds to constitute a common fund for investment purposes only. Collectively, the funds contract with a single firm to provide investment management and counsel services. JFRS's Investment Procurement Policy requires the system to award all investment consultant and advisor services through a competitive proposal process. Through contract, the firm is authorized to make sales and purchases on behalf of the system, but only through brokers approved by the funds. The contracted firm is to operate within the confines of the JFRS Investment Policy Statement of the funds. The JFRS's Investment Policy Statement outlines the systems' investment

objectives and expectations regarding asset allocations, sales and purchases of investments, and communications with the systems' administration. This policy is available to the public through the JFRS website at <https://kjfrs.ky.gov>.

In Fiscal Year (FY) 2018, JFRS membership included a total of 961 members, 597 in Judicial and 364 in Legislative. In that same year, the system had a total of \$513,062,093 in investments, \$395,568,767 in the Judicial Plan and \$117,493,326 in the Legislative Plan. This is an increase of \$32,450,340 from FY 2017.

**Figure 1: Fiscal Year 2018 JFRS Membership by Plan and Member Status**



Source: APA based on the FY 2018 JFRS Financial Statements

## Kentucky Retirement Systems

KRS consists of three individual systems: the Kentucky Employees Retirement System (KERS), created by the General Assembly in 1956, the State Police Retirement System (SPRS), created in 1958, and, the County Employees Retirement System (CERS) also created in 1958. KRS is governed by a 17 member Board of Trustees, consisting of: the Kentucky Personnel Cabinet Secretary, three members from and elected by the membership of CERS, one member from and elected by the membership of SPRS, two members from and elected by the membership of KERS, and 10 appointed by the Governor. The daily operations of KRS and its plans are managed by an Executive Director, appointed by the Board of Trustees.

Per Kentucky Revised Statute 61.650(b)(2), the KRS Investment Committee has the “authority to implement the investment policies adopted by the board and act on behalf of the board on all investment-related matters and to acquire, sell, safeguard, monitor, and manage the assets and securities of the several funds.” KRS contracts with over 100 external investment managers. For contracts and offerings established or renewed on or after July 1, 2017, KRS is required to procure external investment managers and consultants through a competitive selection process. The selection of external investment

managers is initiated by KRS staff and requires review and approval of the KRS Investment Committee, with ratification by its board.

Figure 2 provides a summary count of members and participating employers by individual KRS system in FY 2018, along with total long-term investments held at fair value.

**Figure 2: Total KRS Members, Participating Employers and Long-Term Investments (at fair value) by Individual Retirement System for FY 2018**

<b>KRS System</b>	<b>Total Members</b>	<b>Participating Employers</b>	<b>Investments at Fair Value</b>
Total KERS	134,477	348	\$ 3,780,893,000
Total CERS	242,185	1,139	12,355,681,000
Total SPRS	2,626	1	422,986,000
<b>Grand Total</b>	<b>379,288</b>		<b>\$ 16,559,560,000</b>

Source: APA based on the 2018 KRS Comprehensive Annual Financial Report Combining Statements of Fiduciary Net Position.

Figure 2 identifies total KRS long-term Investments for FY 2018 were over \$16.5 billion. This is an increase of \$705.2 million from FY 2017. Though KRS receives an annual audit, the APA performs the financial statement audit every five years per Kentucky Revised Statute 61.645(12)(b). The FY 2018 Comprehensive Annual Financial Report (CAFR) was performed by the APA and released on December 19, 2018. See the FY 2018 report at [http://apps.auditor.ky.gov/Public/Audit\\_Reports/Archive/2018krsfinancialaudit.pdf](http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2018krsfinancialaudit.pdf).

### **Teachers’ Retirement System of Kentucky**

The Teachers’ Retirement System of Kentucky (TRS) is a state agency established in 1938 to provide retirement to Kentucky teachers across the Commonwealth and began its operations in 1940 after receiving funding from the Kentucky General Assembly. Similar to the other Kentucky retirement systems, TRS is governed by a Board of Trustees and daily management is provided by an Executive Secretary appointed by the board. The TRS Board of Trustees is comprised of 11 members which include the Kentucky Education Commissioner, the Kentucky State Treasurer, two appointed by the Governor, four elected active members of the system, one elected retired system member, and two lay trustees.

Per Kentucky Revised Statute 161.430, the TRS Board of Trustees has the “full power and responsibility for the purchase, sale, exchange, transfer, or other disposition of the investments and moneys of the retirement system.” This statute allows the board to “employ qualified investment staff to advise it on investment matters and to invest and manage assets of the system not to exceed fifty percent (50%) of the system’s assets.” Additionally, the statute does not allow a single investment counselor to manage more than 40% of the funds of the retirement system. For contracts and offerings established or renewed on or after July 1, 2017, TRS is required to procure external investment managers



and consultants through a competitive selection process. TRS had 41 investment managers according to its FY 2018 Financial Statement Audit.

In FY2018, TRS total membership equaled 135,396, with 54,377 retirees and beneficiaries receiving benefits that year. At the same time, the plan had 207 employers participating in the plan including local school districts, universities, Department of Education agencies, the Kentucky Community and Technical College System, and other educational organizations. TRS had \$20,947,875,299 in total investments, reported at fair value, in FY 2018. This is an increase of \$1,514,084,915 from FY 2017.

## **Senate Bill 2**

SB2, which went into effect in early 2017, was codified into law through Kentucky Revised Statutes: 6.350, 7A.220, 7A.255, 21.530, 21.540, 61.645, 61.650, 121.250, 161.340, 161.430, 7A.220. SB2 addressed a number of areas including transparency of fees, contracts, and profit sharing arrangements; retirement system board appointments; procurement policies; and, payments to placement agents. As stated previously, a focus of this examination was on the systems' compliance with certain elements of SB2. Specifically, we examined whether each of the systems disclosed information such as the following required of KRS by Kentucky Revised Statute 61.645(19), which reads:

- (i) All investment holdings in aggregate, fees, and commissions for each fund administered by the board, which shall be updated on a quarterly basis for fiscal years beginning on or after July 1, 2017. The systems shall request from all managers, partnerships, and any other available sources all information regarding fees and commissions and shall, based on the requested information received:
1. Disclose the dollar value of fees and commissions paid to each individual manager or partnership;
  2. Disclose the dollar value of any profit sharing, carried interest, or any other partnership incentive arrangements, partnership agreements, or any other partnership expenses received by or paid to each manager or partnership; and
  3. As applicable, report each fee or commission by manager or partnership consistent with standards established by the Institutional Limited Partners Association (ILPA).

In addition to the requirements of this paragraph, the systems shall also disclose the name and address of all individual underlying managers or partners in any fund of funds in which system assets are invested.

- (j) An update of net of fees investment returns, asset allocations, and the performance of the funds against benchmarks adopted by the board for each fund, for each asset class administered by the board, and for each manager. The update shall be posted on a quarterly basis for fiscal years beginning on or after July 1, 2017.

(l) All contracts or offering documents for services, goods, or property purchased or utilized by the systems.

Kentucky Revised Statute 21.540(4) and Kentucky Revised Statute 161.250(4) contain similar requirements for JFRS and TRS, respectively. Figure 3 provides a summary of the examination findings related to each systems’ non-compliance with regards to specific sections of SB2. An X indicates the system is identified as non-compliant.

**Figure 3: Retirement Systems’ Areas of Non-Compliance with Senate Bill 2  
Public Disclosure Requirements**

<b>Public Disclosures:</b>	<b>JFRS</b>	<b>KRS</b>	<b>TRS</b>
Disclose dollar value of any profit sharing, carried interest, or any other partnership incentive			X
Disclose the name and address of all individual underlying managers or partners in any fund of funds in which system assets are invested			X
All contracts or offering documents for services, goods, or property purchased or utilized by the systems.		X	X

Source: APA based on sample tested.

As demonstrated in Figure 3, KRS is identified as non-compliant with SB2 for failing to present publicly all contracts or offering documents, see Finding 2 (page 16). TRS is identified as non-compliant for not presenting publicly all contracts or offering documents and for not disclosing the names and address of all individual underlying managers or partners in any fund of funds in which the system has invested assets, see Finding 4 (page 18-22). Additionally, TRS failed to disclose the dollar value of carried interest, see Finding 5 (page 23-24).

In addition to the above transparency elements of SB2, this examination reviewed compliance by the systems as it relates to adherence to Chartered Financial Analyst (CFA) Institute Code of Ethics and Standards of Professional Conduct, Asset Manager Code of Professional Conduct, and Code of Conduct for Members of a Pension Scheme Governing Body. The results of this inquiry are summarized in Figure 4. Again, an X in the chart indicates the system is identified as non-compliant.

Figure 4: Retirement Systems' Compliance with Select CFA Institute Codes

CFA Institute Adherence:	KRS	TRS
Code of Ethics and Standards of Professional Conduct (applies to system investment staff, investment managers, board members)	✘	
Asset Manager Code of Professional Conduct (applies to individual managing system assets)	✘	

Source: APA based on inquiry performed by this office.

JFRS was not evaluated for adherence to CFA Institute Codes as indicated by the system's exclusion from Figure 4. SB2 did not make adherence to CFA Institute Codes a requirement for that system. Rather, SB2 reconfirmed JFRS's fiduciary duty for investment managers, found under Kentucky Revised Statute 21.540(5), and JFRS's conflict of interest provisions found in Kentucky Revised Statute 21.450(2).

KRS was found non-compliant in adherence of the CFA Code of Conduct because the system had not notified all general partners of the requirements of SB2. In 2019, the Kentucky General Assembly passed a new bill, House Bill 489, revising these requirements.

### House Bill 489

On March 25, 2019, House Bill 489 was signed into law. This bill removes the requirement for Investment Managers to adhere to the CFA Code of Ethics and Standards of Professional Conduct and instead, requires Investment Managers to comply with the federal Investment Advisers Act of 1940. The Investment Advisers Act of 1940 is federal law administered by the Securities and Exchange Commission. The bill also removes the requirement for board trustees to adhere to the CFA Code of Ethics and Standards of Professional Conduct; however, board members are still required to adhere to the CFA Code of Conduct for Members of a Pension Scheme Governing Body. No changes were made to the requirements of internal investment staff and investment consultants who work for the retirement systems in developing overall investment strategies and identifying potential investment managers. In light of these recent changes, KRS's non-compliance in this was moot as of March 25, 2019. As such, these matters will not be discussed further in this examination report.

## **CHAPTER II: CONTRACT TRANSPARENCY**

In Chapters II through III of this report, the terms private equity investment, general partner, and limited partner will be mentioned. In the simplest of terms, a private equity investment is managed by a private equity firm that serves as the general partner. The general partner manages the investment and the investors who invest in the private equity fund are the limited partners. A limited partner's total liability is limited to the extent of the capital invested.

### **Finding 1: KRS has Abdicated its Responsibility to Abide by the Open Records Act**

Although KRS has complied with certain elements of SB2, including reporting investment holdings in aggregate, fees, and commissions, and reporting quarterly net of fees investment returns, asset allocations and fund performance compared to established benchmarks, the agency has not ensured compliance with all requirements of the bill. KRS has not presented all investment manager contracts on its website and has delegated its responsibility to redact confidential and proprietary information from those contracts to external investment managers. By abdicating its responsibility, KRS has allowed external investment managers to control access to public information.

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KRS allows external investment managers to control access to public information.

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Investment manager contracts presented on the KRS website are highly redacted. Redactions are allowed based on Kentucky Revised Statute 61.645(20) which states, "Notwithstanding the requirements of subsection (19) of this section, the retirement systems shall not be required to furnish information that is protected under Kentucky Revised Statute 61.661, exempt under Kentucky Revised Statute 61.878, or that, if disclosed, would compromise the retirement systems' ability to competitively invest in real estate or other asset classes...If any public record contains material which is not excepted under this section, **the systems shall** separate the excepted material by removal, segregation, or redaction, and make the nonexcepted material available for examination" (emphasis added).

Initially we reviewed three KRS Investment Manager contracts posted online. Information was redacted in at least one or more of the following areas contained in all three contracts:

- Conflicts of Interest
- Incentive Allocation
- Expenses/Fees
- Duty of Care; Indemnification
- Allocation of Net Profit and Net Loss
- Management Fees
- Side Letters

- Investment Advisors Act
- Investment-Related Definitions
- Investment Opportunities and Limitations

The name of the vendor and the date of the contract, with the exception of the year, was redacted on most contracts. General statements such as “The Investment Manager shall select and monitor Brokers in good faith” and various Table of Content section headers were also redacted. While KRS indicates redactions made by the external investment managers are considered proprietary and confidential business information, unnecessary redactions such as these were identified.

KRS stated that it does not redact anything from these contracts. According to KRS, the individual managers will decide what they consider to be a “trade secret” and redact their documents accordingly. However, Kentucky Revised Statute 61.645 places the responsibility of redacting information on the retirement system. KRS developed a “gating” process for all contracts initiated after April 2017 in an effort to ensure SB2 requirements are included in the contracts going forward.

### “Gating” Process

After SB2 passed on February 27, 2017, the KRS executive team, investment staff, investment operations staff, and investment compliance staff sent letters to public equity and fixed income managers explaining the provisions of the statute. Managers who received the letter were the same 33 managers for which contracts had been presented on the KRS website as of February 14, 2019. KRS postponed sending letters to alternative investment managers until the legality of disclosing contracts of a general partner could be established. Alternative investments can include private equity, hedge funds, and real estate investments.

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KRS postponed notification of SB2 requirements to alternative investment managers until the legality of disclosing contracts of a general partner could be established.

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KRS stated that the letter to public equity and fixed income managers was based on external investment legal counsel’s review of SB2 requirements. In this letter, KRS asked managers to provide redacted versions of relevant partnership agreements and contracts through a cover letter, see sample letter at Appendix A. They further asked that redactions be limited to only proprietary information or what would be considered exempt under Kentucky’s Open Records Act. Upon receiving the redacted documentation, KRS stated they would review the redactions for reasonableness and then post the documents to their website.

A footnote in the letter to investment managers explains the basis by which redactions can be made. It states:

The basis for redaction could invoke the exception to disclosure for “records confidentially disclosed to an agency or required by an agency to be disclosed to it, generally recognized as confidential or proprietary, which if openly disclosed would permit an unfair commercial advantage to competitors of the entity that disclosed the records.” See Kentucky Revised Statutes section 61.878(1)(c)(1). Fee terms, however, are expressly required to be disclosed, and may not be redacted.

As previously noted, this requirement did not go into effect until February 27, 2017. Therefore, it does not affect managers and contracts established prior to this date. Review determined investment managers procured after this date still redacted fee terms, and no action was taken by KRS to ensure this information was made available to the public. According to the KRS Executive Director of the Office of Investments, some invest managers choose to redact their fee schedules from their contracts because they have negotiated special fees with KRS and do not want that publicized.

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Investment managers redacted fee terms, and no action has been taken by KRS to ensure this information is publicly disclosed.

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Though requested by KRS, no cover letters containing explanations were provided by any investment managers for the redactions made to their contracts. The KRS Executive Director explained that KRS staff generally review every contract and that management encourages “surgical redaction” rather than “wholesale redaction” in hopes that the managers will only redact one line or statement and not an entire paragraph. Further, the Executive Director stated while KRS does a general review of the contracts, they do not give an opinion on the redactions unless they are outright onerous. As previously noted, some redactions seem completely unnecessary such as the redactions made to the Table of Contents, the manager’s name, and date.

The KRS Executive Director of the Office of Investments could only recall negotiating with one manager about redactions. This negotiation was conducted by phone so no written documentation of this negotiation was created or maintained. Per KRS, the investment manager with whom they negotiated claimed the entire contract was proprietary. As such, this contract still has not been posted to the KRS website. See Finding 2 (page 16), for further discussion of KRS’s compliance with public disclosure requirements.

The former Office of Operations’ Executive Director stated KRS is not in a legal position to determine what an investment manager can or cannot redact. KRS advised that all of the newly established partnership contracts contain a confidentiality provision. Furthermore, general partners have a variety of remedies under the terms of the agreement, which include holding KRS liable for any damages. KRS has not obtained clarification

from the Attorney General in order to define what financial data should be considered proprietary or confidential. Ultimately, what is considered proprietary and confidential would be determined by the courts.

Ten additional KRS investment manager contracts were reviewed to examine the public disclosure terms. Of the additional ten contracts reviewed, two are redacted and posted online, and eight are entirely withheld from public view by KRS. Each of these additional contracts reviewed included some variation of language recognizing that disclosure laws may exist and some disclosure by the system may be required by law.

One contract reviewed during fieldwork contained a partially redacted section related to confidentiality, which appears to contradict the argument that KRS is not in a legal position to determine what an investment manager can redact. Within this section, the following was noted (see Appendix B for full excerpt and Appendix C for redacted version of Exhibit B as posted on the KRS website):

...the Partnership hereby acknowledges that KRS is a public agency subject to (i) Kentucky's public records law (the "Open Records Act," Kentucky Revised Statutes section 61.870 to 61.884), which provide generally that all records relating to a public agency's business are open to public inspection and copying unless exempted under the Open Records Act, (ii) Kentucky Revised Statutes section 61.645(19)(i) (the "Fee Disclosure Law") and (iii) Kentucky Revised Statutes section 61.945(19)(I) and (20) (the "Document Disclosure Law"), which provide generally that all contracts or offering documents for services, goods, or property purchased or utilized by KRS shall be made available to the public unless exempted under the Document Disclosure Law. Notwithstanding any provision in this Agreement or the Subscription Agreements to the contrary, the Partnership hereby agrees that (x) KRS will generally treat all information received from the General Partner or the Partnership as open to public inspection under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, unless such information falls within an exemption under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, and (y) KRS will not be deemed to be in violation of any provisions of this Agreement or the Subscription Agreements relating to confidentiality if KRS discloses or makes available to the public (e.g., via KRS' website) any information regarding the Partnership to the extent required pursuant to or under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, including the Fund-Level information described in paragraph (c) below (even if a court or the Attorney General later determines that certain information disclosure by KRS falls within an exemption under the Open Records Act, the Fee Disclosure Law, or the Document Disclosure Law)...

Though the Open Records Act provides for exemptions, it does not require agencies to use the exemptions; rather, exemptions are optional. In at least one of the contracts reviewed, the system, as a limited partner in the investment, is required to notify the general partner of required disclosure and assist the general partner to “oppose and prevent the required disclosure.” Proprietary exemptions place KRS in a position of conflict between the external interest of the contractor and the public interest of the average taxpayer.

## **Recommendations**

We recommend KRS:

- Modify its “gating” process to require investment managers to provide a detailed explanation of all redactions made to contracts and track significant information about those redactions. Tracking should identify the text of redactions, the basis for the redactions, any actions taken or communications by KRS to confirm the redactions, and KRS approval or rejection of the redactions. For rejections, KRS should ensure proper documentation is maintained to support their actions and notify the manager of its decision.
- Begin posting all investment-related contracts once vetted through the gating process. Older contracts in the process of being renegotiated should include language allowing KRS to publish an investment manager’s contract and limit their liability.
- Request clarification by seeking an opinion from the Kentucky Attorney General to define what financial data should be considered proprietary or confidential in each contract. Senate Bill 2, Kentucky Revised Statute 61.645, and Kentucky Revised Statute 61.878 acknowledge the need to protect certain information and allow KRS to post contracts online with redactions. Some managers allow KRS to report their contract online with redactions. However, private equity firms claim their contracts as a whole are proprietary. A ruling by the Kentucky Attorney General would help clarify what specific information should be redacted and what should be made available to the public.

Report continues with Finding 2 on next page.



**Finding 2: KRS Does Not Post Contracts as Required by Senate Bill 2**

SB2 requires the disclosure of all contracts. However, not all contracts are being posted on the KRS website. As of August 13, 2019, KRS indicated it has 281 contracts with investment managers. Based on this information, only 14 percent of KRS’s 281 investment manager contracts have been uploaded to its public website. However, the number of contracts has not been found to be reliable because KRS’s contract process is manual and repeated requests for a total number of contracts resulted in conflicting information. Figure 5 summarizes, by asset class the total number of KRS investment contracts along with the percentage of contracts not presented on its website as of August 13, 2019.

Approximately 86% of KRS investment manager contracts are not posted online.

**Figure 5: Total Number of KRS Contracts by Asset Class and Percentage of Contracts Not Posted, as of August 13, 2019**

KRS Contracts									
	Fixed Income	Public Equity	Real Return	Private Equity	Real Estate	Special Credit	Absolute Return	Opportunistic	Total
Number of Contracts	9	12	22	142	26	14	54	2	281
Number of Contracts Not Posted Online	5	1	14	142	19	6	54	2	243
Percentage Not Online	55.56%	8.33%	63.64%	100.00%	73.08%	42.86%	100.00%	100.00%	86.48%

Source: Chart based on data provided by KRS. Data was not confirmed. There is no source to independently verify this data.

As identified by Figure 5, the contracts not loaded to the KRS website primarily consist of private equity managers.

Of the 13 KRS investment contracts reviewed, nine referenced to an associated “side letter.” The side letters contain confidentiality provisions and additional information related to the associated contract. The letters contain additional provisions on which KRS and the contractor have agreed. Though side letters appear to be an integral part of the contractual agreement between KRS and investment managers, they are not posted with the contract on the KRS website. KRS management stated that shortly after the legislation passed requiring the posting of contracts, internal counsel decided that posting the limited partnership agreements would satisfy the requirements of the law.

**Recommendations**

We recommend KRS:

- Ensure all contracts are posted online as required by Senate Bill 2, including any side letters associated with the contract as those are part of the agreement between the system and the external investment manager.

**Finding 3: KRS is Not Monitoring its Investment Managers Consistent with its Investment Policy**

Using the FY 2018 CAFR, it was determined KRS had 110 investment managers, and TRS had 41 investment managers as of June 30, 2018. JFRS only has one investment manager. While SB2 does not limit the number of investment managers, this matter could impact KRS's ability to properly manage and maintain a cohesive investment strategy and to manage transparency of its contracts.

KRS has staff dedicated to the management of all investments types (public equity, private equity, etc.). Discussions with KRS staff revealed hedge funds and private equity are the most difficult to review due to staff turnover. It is a requirement of KRS's investment policy to meet with all investment managers once a year prior to the contract expiration, but this process has been waived due to the shortfall of staff. At this time, KRS is having quarterly review calls with every public manager and periodic reviews with all partnerships. KRS confirmed investment staff met with two managers in March 2019.

KRS management indicate a desire to reduce the number of private equity managers but is currently waiting for investments in some limited partnerships to expire before beginning this reduction. No formal plan has been developed or presented to the Board to accomplish these goals.

**Recommendation**

We recommend KRS management:

- Discuss with the board a plan to decrease the number of investment contracts. Specific consideration should be given to reducing the number of contracts with private equity managers, or alternative investments. This should allow KRS to properly monitor investment managers, maintain a cohesive investment strategy, and manage contracts more effectively.

Report continues with Finding 4 on next page.

**Finding 4: TRS Does Not Post Contracts and Does Not Disclose Contact Information for Fund of Funds as Required by Senate Bill 2**

Senate Bill 2 requires retirement systems to disclose the name and address of all individual underlying managers or partners in any fund of funds in which system assets are invested. A fund of funds is a pooled investment that invests in other types of funds. TRS does not comply with this portion of the bill. Additionally, TRS has not posted all contracts on its website as required by SB2, and redactions made to posted contracts appear excessive.

**Fund of Funds**

A fund of funds is an investment strategy of holding a portfolio of other investment funds rather than investing directly in stocks, bonds, or other securities. This type of investing is referred to as “multi-manager investment”. While TRS maintains a list of external managers online, they do not report names and addresses associated with the underlying managers in fund of funds as such information was deemed to be confidential and proprietary by TRS management.

**Contracts**

Kentucky Revised Statute 161.250 requires the disclosure of all contracts for services, goods, or property purchased. However, not all contracts are posted on the TRS website. According to the TRS website, “Pursuant to Senate Bill 2 of the 2017 Regular Session of the General Assembly, contracts are posted on this page. *This page is updated as needed.* Confidential and proprietary information in those contracts is redacted in accordance with Kentucky law. If a fund is listed without a link to the contract, TRS remains in the process of reviewing that contract.”

There are 31 investment manager contracts posted on the TRS website as of July 26, 2019. TRS uses 41 investment firms, two of which serve as both a traditional fund manager and as a general partner of private equity investments. According to TRS, the investment manager contracts not posted to the TRS website total 136 and pertain to private equity investments, which TRS considers proprietary as a whole. TRS’ website lists the investment funds for which it asserts the entire contract is confidential and proprietary. Each investment fund may have more than one contract with TRS, as an investment fund may be contracted in association with one or more of TRS’ funds: pension fund, medical fund, and insurance fund. Figure 6 summarizes these contracts by TRS fund and investment type.

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Approximately  
81% of investment  
manager contracts  
are not posted on  
TRS’ website.

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**Figure 6: Total Number of TRS Contracts by Asset Class and Percentage of Contracts Not Posted, as of July 26, 2019**

TRS Contracts							
	Fixed Income	Domestic Equity	International Equity	Real Estate	Alternative	Additional Categories	Total
Number of Contracts	2	10	10	36	83	26	167
Number of Contracts Not Posted Online	0	0	0	36	83	17	136
Percentage Not Online	0.00%	0.00%	0.00%	100.00%	100.00%	65.38%	81.44%

Source: Chart based on data provided by TRS. Data was not confirmed. There is no source to independently verify this data.

As demonstrated by Figure 6, the majority of TRS’s funds with contracts not posted online are categorized as alternative investments, which includes private equity investments. As noted in Finding 2 (page 16), the majority of KRS’ funds with contracts not posted online were also private equity investments.

Investment manager contracts housed on the TRS website contain information which is redacted. Again, some redactions are allowed per Kentucky law. Specific to TRS, Kentucky Revised Statute 161.250(5) states:

Notwithstanding the requirements of subsection (4) of this section, the retirement system shall not be required to furnish information that is protected under KRS 161.585, exempt under KRS 61.878, or that, if disclosed, would compromise the retirement system’s ability to competitively invest in real estate or other asset classes, except that no provision of this section or KRS 61.878 shall exclude disclosure and review of all contracts, including investment contracts, by the board, the Auditor of Public Accounts, and the Government Contract Review Committee established pursuant to KRS 45A.705 or the disclosure of investment fees and commissions as provided by this section. If any public record contains material which is not excepted under this section, the system shall separate the excepted material by removal, segregation, or redaction, and make the nonexcepted material available for examination.

TRS has a process in place to redact information. For contracts dealing with public equities, fixed income, and investment support, redacted information typically includes signatures, insurance requirements, and sections dealing with fees. TRS explained that signatures are redacted for security reasons; insurance requirements and sections dealing with fees are redacted in accordance with Kentucky Revised Statute 161.250 because such a release would compromise TRS’s ability to invest competitively; and some managers have asserted that information is confidential and proprietary and exempt from release under Kentucky Revised Statute 61.878. For private equity contracts, as previously noted, all managers have asserted that the contracts in their entirety should not be released because they are confidential and proprietary.

A sample of seven TRS contracts were reviewed during fieldwork to better understand the material not publicly disclosed by the system. Content areas redacted or containing redactions included, but were not limited to:

- Liability/Indemnification
- Confidentiality
- The manager and TRS representative signatures
- Fees
- Name of fund

Within one contract, references to resource materials available to the investors were redacted, as well as, the terms “Proprietary and Confidential.” Most contracts reviewed referenced the Open Records Act and stated that no claim would be made if information was made available to the public in good faith.

Redaction requests by vendors/managers are made in writing to TRS. The system states, having agreed to the terms of its contracts, it is contractually bound to honor those requests unless the request is in clear violation of public access laws. Some redactions are made by TRS, without the request of the manager, under Kentucky Revised Statute 161.250 if TRS determines the release would compromise their ability to invest competitively. Once all redactions are made, the redacted contract is loaded to the TRS website. TRS does not maintain a log to identify the redactions made and by whom.

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TRS makes some redactions to contracts, without a request from an external investment manager, if it determines the release would compromise its ability to competitively invest.

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As noted with the KRS contracts, many of the TRS contracts reviewed referenced to a side letter containing confidentiality provisions associated with the contracts. Of the seven TRS contracts reviewed, five referenced to a side letter. While the side letters are part of the parties’ agreement, none of these documents are posted on the TRS website. The TRS Deputy Executive Secretary stated that these were “not deemed particularly relevant.” Because the contract refers to a side letter, and the letters contain contract provisions by which both TRS and the contractor have agreed, it is unreasonable to consider this information not relevant when transparency laws encourage contracts to be publicly presented.

TRS notified all investment managers of the relevant SB2 provisions and possible public disclosures via letter in October 2017. A copy of one of these letters can be found in Appendix D. An Investment Summary document was attached to this letter, which includes information TRS expected to disclose. The information reported on the Investment Summary is high level and is provided by TRS in response to all open records requests.

TRS stated in this letter they did not have the background or knowledge to identify information which could be used by competitors. As such, they asked their General Partners to assist them with identifying this information and removing, segregating, or redacting the material that should be excluded from public access. TRS personnel called investment managers at the time the letters were mailed to explain the letter before it was received. Per TRS, most managers requested a listing of proprietary items and TRS responded with a list of items they say one General Partner considered to be proprietary and confidential, which includes:

- Due diligence materials of the Partnership;
- Quarterly and annual financial statements of the Partnership;
- Meeting materials of the Partnership;
- Records containing information regarding the portfolio positions in which the Partnership invests;
- Capital call and distribution notices of the Partnership;
- Partnership agreements, investment advisory agreements, side letter agreements and all related documents provided to the Investor in connection with the Investor's interest in the Partnership;
- Offering documents, including, without limitation, private placement memoranda, pitch books and marketing presentations;
- The dollar value of fees and commissions paid to the Investment Advisor or the Partnership, other than Fund Level Information;
- The dollar value of any profit sharing, carried interest, or any other partnership incentive arrangements, partnership agreements, or any other partnership expenses received by or paid the Investment Advisor or the Partnership, other than Fund Level Information;
- Populated reports consistent with the Institutional Limited Partners Association (ILPA) templates;
- The name and addresses of all individual underlying managers or partners in any fund of funds in which the Investor is invested; and
- Any other reports or communications received from the Partnership in connection with the Investor's Interest therein.
- Any other materials that the General Partner provides to the Investor that are labeled "Confidential" or "Proprietary".

Many of the items listed as potentially proprietary in TRS's response are required by SB2 to be disclosed. As such, TRS will not fully comply with SB2 if these items are allowed to be marked as confidential and proprietary. TRS advised managers that this was just the opinion of one General Partner and that they may choose to remove items from this list if they do not consider them proprietary and confidential. The Open Records Act provides for exemptions, but it does not require agencies to use the exemptions; rather, exemptions are optional. As noted previously, proprietary exemptions place the agency in a precarious position of conflict between the private interest of external investment partners and the public interest of taxpayers.

Discussions with TRS management revealed they have not obtained clarification from the Attorney General in order to define what financial data should be considered proprietary or confidential. However, they indicated that they worked closely with a now former Kentucky Attorney General Executive Staff member to ensure they were making available all non-confidential information. The former Attorney General Executive Staff member identified by TRS retired August 31, 2016, before the effective date of SB2.

## **Recommendations**

We recommend TRS:

- Comply with Senate Bill 2 by disclosing the names and addresses of all individual underlying managers or partners in any fund of funds in which TRS' assets are invested.
- Track all redactions to contracts required to be disclosed by Senate Bill 2. Tracking should identify the text of redactions, the necessity for the redactions, any actions taken or communications by TRS to confirm the redactions, and TRS approval or rejection of the redactions. For rejections, TRS should ensure proper documentation is maintained to support their actions and notify the manager of its decision.
- Request clarification by seeking an opinion from the Kentucky Attorney General to define what financial data should be considered proprietary or confidential in each contract. Senate Bill 2, Kentucky Revised Statute 161.250, and Kentucky Revised Statute 61.878 acknowledge the need to protect certain information and allow TRS to post contracts online with redactions in order to protect business. Some managers are allowing TRS to report their contract online with redactions. However, private equity firms claim their contracts as a whole are proprietary. A ruling by the Kentucky Attorney General would help clarify what specific information should be redacted and what should be made available to the public.

Report continues with Chapter III on next page.

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## **CHAPTER III: CARRIED INTEREST TRANSPARENCY**

### **Finding 5: TRS Does Not Report Carried Interest in a Transparent Manner as Required by Senate Bill 2**

As part of SB2, Kentucky Revised Statute 161.250(4)(i)(2) states TRS shall “[d]isclose the dollar value of any profit sharing, carried interest, or any other partnership incentive arrangements, partnership agreements, or any other partnership expenses received by or paid to each manager or partnership.” While profit sharing/carried interest is reported by TRS on the financial statements, it is not reported in a manner to allow the public to easily identify the amount earned in association with TRS investments.

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Carried interest is the amount of a private equity or a hedge fund’s profits that the general partner or investment manager receives as compensation.

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TRS and KRS define and report carried interest differently. KRS recognizes carried interest as a line item on its financial statements, as part of its performance fees. TRS stated it does not consider carried interest to be a fee as carried interest represents a general partner’s share of a partnership’s profits. Carried interest in the private equity market is typically split 20% to the general partner, also known as the investment manager, and 80% to the limited partner, which in this case is TRS. TRS stated that before the general partner takes profits, TRS must be paid back its capital investment, interest on the capital investment, and management fees. Regardless of whether carried interest is identified as a fee, it is clearly profit that contracted investment managers are making from the systems’ investments and is required to be reported by SB2.

TRS management claims carried interest is proprietary and is reported on the financial statements by netting it against income. As such, even though it is being reported on the financial statements and in the CAFR, which are available on the TRS website, it is not being reported in manner that is transparent or consistent with the intent of the legislation.

Of the 81 funds managed by TRS external investment managers, 72 report carried interest to TRS. Three of TRS’s funds do not earn carried interest. TRS stated the remaining six funds are older, and the General Partners managing these funds do not believe it is worth providing the associated carried interest, as such this information is not reported to the system. TRS has not pursued obtaining the information from those six funds.

TRS reports its share of partnership profits, income and expenses on its financial statements. TRS originally stated it has no incentive arrangements with partnership investments. Yet, it also said it does not publish partnership agreements or any other partners’ share of profits. The General Partners of each TRS partnership investment have invoked limited partnership agreements to prevent the public release of confidential and proprietary business information.



## **Recommendation**

We recommend TRS:

- Comply with SB2 by reporting carried interest as a performance fee in order to capture all amounts paid to investment managers in association with TRS's investments.

Report continues with Chapter IV on next page.

## **CHAPTER IV: FEE CONTROLS**

### **Finding 6: KRS Was Unable to Recalculate One Investment Manager's Fees During FY 2018 Due to a Lack of Information and Understanding of the Fee Calculation**

Beginning in 2016, prior to the passage of SB2, KRS requested investment managers submit management, performance, and incentive fees on their monthly statements and invoices. Quarterly reporting requirements established by SB2 reinforced the need for reporting of such information to the system. While most managers complied with this request, six private equity investment managers did not comply. KRS identified these as older companies having less than \$100,000 in investments, which means the fees associated with these investments are low. These companies are IVP XII, H/2 Credit Partner, OCM VIIB, Sun Capital, TCV, and PIMCO All Asset – Real Return.

KRS reconciles the management and performance fees charged by more than 100 managers monthly to ensure the fees agree with the contracted rate. Reconciliations are broken out by the following asset classes – private equity, real estate, real return, absolute return, fixed income and public equity. KRS noted that this review is actually doubled since each manager reports by Pension and Insurance funds.

Documented procedures are in place and used to perform the reconciliations. As part of its process, KRS performs calculations for both the performance and management fees and compares that to amounts charged by the investment manager for the month. KRS then totals the management and performance fees associated with the Pension and Insurance funds to determine the difference and then calculates a percentage representing the discrepancy. Per KRS procedure, all manager fees should be within +/- 5%. If the manager fees exceed this threshold, the KRS staff member may contact the Director of the asset class, the custodian, and/or the investment manager to determine what caused the variance.

Since KRS negotiates fee rates as part of the contracts, inquiry was made as to how there are ever differences noted during the reconciliation. KRS stated there are several reasons why this would occur including the timing of the calculation, managers calculating at the fund level and then distributing the fee by ownership, and managers using the average daily balance versus balances at a specific point in time. These issues are not identified or discussed in the manager's contracts. Parties to the agreement should be able to readily identify within their contract how they are calculating the monthly management and performance fees.

Prisma Capital (Prisma) is an investment manager within the absolute return asset class that had more than a 5% discrepancy for their performance fees. While examining the reconciliation of this firm's fees as an example it was noted that the original reconciliation provided by KRS was missing the manager's fee amounts for December 2017, January 2018, February 2018, April 2018, and May 2018. According to the Assistant Director of the Investment Operations Branch (Assistant Director), the reconciliation for

these months could not be completed since KRS was missing necessary information from the investment manager to perform the calculation. KRS specifically noted that Prisma incorporates a fluctuating rate.

Since KRS did not obtain the necessary information, it relied on Prisma's performance fee calculations for the noted months. These fee totals were reviewed by KRS for reasonableness. KRS confirmed Prisma is the only manager that they have to reach out to for additional information or help with the calculation.

After further inquiry on April 24, 2019, KRS staff advised that they were able to calculate the fees for Prisma for January – June 2018 using the contract, their reconciliation spreadsheet and monthly statements provided by Prisma. The KRS Assistant Director noted that the calculation was confusing and indicated that the formula used was different from how the rate was calculated by Prisma. KRS is waiting on additional statements from Prisma in order to recalculate the performance fees for July 2017 – December 2017. Since KRS's calculation differs from that used by Prisma since the date the contract was initiated through FY 2018, it is unclear how KRS determined the fees charged by Prisma were reasonable when KRS did not know how to calculate these fees during the audit period.

### **Recommendations**

We recommend KRS:

- Ensure investment manager contracts clearly identify how management and performance fees will be calculated. If KRS does not understand the calculation, its staff should conduct follow-up with investment managers to better understand the calculation rather than rely upon the investment manager to provide the calculation. Ideally, this clarification would be obtained prior to signing the contract.

Report continues with Finding 7 on next page.

**Finding 7: TRS Uses Fee Caps in Some Contracts; KRS Does Not**

KRS and TRS process fees differently. TRS has several contracts that have caps, or limits, that were determined during contract negotiations. This allows TRS to set a ceiling for the fees they will pay a manager. KRS pays fees strictly based on the assets under management and investment returns. TRS contracts that contain caps state that “TRS reserves the authority to adjust quarterly billing and payments if an unusually large amount of annual cap would be paid prior to the 4<sup>th</sup> quarter of the fiscal year.” This allows TRS to smooth the quarterly payments to a manager so as not to pay more than allowed by the contract.

**Administrative Fees**

According to the FY 2018 CAFR for TRS and KRS, the following investment-related administrative fees were recorded:

Figure 7: KRS and TRS Administrative Fees Charged in FY 2018

<b>Investment-Related Administrative Fees</b>	<b>KRS</b>	<b>TRS</b>
Administration Fees	✓	
American Depository Receipts Fees	✓	
Commission on Future Contracts	✓	
Consultant Fees	✓	✓
Corporate Action Fees	✓	
Counselor (Investment Advisory) Fees	✓	✓
Custodian Fees	✓	✓
Fee for Long Balance	✓	
KPMG Auditing Fees	✓	
Legal & Research		✓
Miscellaneous	✓	
Other (Administrative & Operational)	✓	✓
Partnership Expenses	✓	
Performance/Incentive (Carried Interest) Fees	✓	
Security Lending Fees/Rebates	✓	
Stock Loan Fees	✓	
Taxes & Insurance	✓	
Taxes Withheld from LP Dist (limited partner distributions)	✓	

Source: APA based on FY 2018 KRS CAFR and FY 2018 TRS CAFR.

As identified by Figure 7, the number of administrative fee categories reported by KRS outnumber that reported by TRS. The types of administrative fees charged in association with investments may vary depending on the asset class and the investment.

Because TRS does not transparently report the carried interest associated with its investments, a comparison of fees paid by each Kentucky system to the total assets recorded by the systems for FY 2018 could not be performed. Excluding the carried interest from TRS's costs and including those same costs in the fees for KRS would unfairly present a lower percentage of costs to assets for TRS. See Finding 5 (page 23-24) for further discussion of TRS's reporting of carried interest.

### **Recommendation**

We recommend KRS:

- Consider negotiating fee caps and include language in its investment manager contracts giving KRS clear authority to reduce payment of fees once the fees near the agreed cap amount, similar to TRS.

Report continues with Chapter V on next page.

## **CHAPTER V: DELINQUENCIES AND PENALTIES**

### **Delinquencies**

KRS participants are required to contribute monthly to system plans. The amount of required contributions are determined based on actuarial calculations, which look at a number of factors such as the value of current assets, number of plan participants, and anticipated rates of return on future investments. Beyond standard monthly contributions, employers are required to pay costs associated with additional expenses such as health insurance reimbursement, pension spiking, and standard sick leave.

Health insurance reimbursement is billed to employers when they have reemployed a retired KRS member who is covered under KRS-provided health insurance. This reimbursement is for health insurance premiums paid for those members.

Pension spiking occurs when a state employee or employer attempts to inflate the employee's retirement allowance with raises or positions that are not bona fide promotions or career advancement in the years prior to retirement. Under Kentucky law, the employee's last employer is responsible for paying the additional costs associated with pension spiking.

Depending on the plan a participant contributes to and when the participant began participating in the system, a member may be eligible to receive sick leave service credit to apply toward retirement. This means when an eligible employee retires, their remaining balance of sick leave hours upon retirement may be used to increase the retirees' benefit allowance. State statutes require any sick leave credit that a member has accumulated since July 1, 2010 be paid to KRS by the member's last employer based on a formula established by the KRS Board. The bill associated with standard sick leave will be issued to the employer approximately three months after the member retires.

### **Penalties**

Kentucky law allows KRS to penalize employers participating in the Kentucky Employees Retirement System or the County Employees Retirement System if they fail to file all contributions and reports on or before the tenth day of the month by applying interest on delinquent contributions. The interest on the delinquent contributions is at the actuarial rate adopted by the board and compounded annually. The FY 2018 financial statement audit released by the APA on December 19, 2018, included a finding that KRS's management waived delinquent penalty payments for 95 employers, totaling more than \$104,000 that fiscal year. No legal authority was identified to allow management to waive such penalties. In the spring of 2019, prior to the end of examination fieldwork, House Bill 80 was passed which, among other things, changed the statutory language making the penalty optional rather than mandatory. APA financial auditors recommended that if penalty waivers are allowable, KRS should adopt formal written policies and procedures on waiving penalties, which should be approved by the KRS Board of Trustees. Auditors

further recommended that KRS management provide the Board of Trustees with a regular report of any penalties waived under the policy.

## KERS

Kentucky Revised Statute 61.675 pertains specifically to KERS. Prior to 2019 House Bill 80, Kentucky Revised Statute 61.675(3)(a) stated:

Any agency participating in the Kentucky Employees Retirement System which is not an integral part of the executive branch of state government shall file the following at the retirement office on or before the tenth day of the month following the period being reported:

1. The employer and employee contributions required under KRS 61.560, 61.565, and 61.702;
2. The employer contributions and reimbursements for retiree health insurance premiums required under KRS 61.637; and
3. A record of all contributions to the system on the forms prescribed by the board.

Subsection (3)(b) went on to state:

If the agency fails to file all contributions and reports on or before the tenth day of the month following the period being reported, interest on the delinquent contributions at the actuarial rate adopted by the board compounded annually, but not less than one thousand dollars (\$1,000), *shall* be added to the amount due the system” (emphasis added).

As of February 28, 2018, 120 employers did not submit their contributions and other files to KRS on time and were charged a monthly reporting penalty of \$1,000. The remaining 677 employers either submitted their information on time and were not charged a monthly reporting penalty, but had other delinquencies, or they are considered by KRS as “integral” to the executive branch, and therefore, would not be charged a monthly reporting penalty. KRS confirmed they have a total of 1,466 employers that currently report to them on a monthly basis.

Discussion with KRS management revealed KRS has sued Kentucky River Community Care for failure to properly report employees and pay employer and employee contributions. KRS management noted the reason an employer does not report and pay the monthly employer contributions is often due to the fact that the agency does not have the money to do so.

## CERS

Prior to 2019 House Bill 80, Kentucky Revised Statute 78.625(2)(a), which pertains to CERS, stated:

If the agency reporting official fails to file at the retirement office all contributions and reports on or before the tenth day of the month following the period being reported, interest on the delinquent contributions at the actuarial rate adopted by the board compounded annually, but not less than one thousand dollars (\$1,000), *shall* be added to the amount due to the system” (emphasis added).

Subsection (2)(b) states:

Delinquent contributions, with interest at the rate adopted by the board compounded annually, or penalties may be recovered by action in the Franklin Circuit Court against the county liable or may, at the request of the board, be deducted from any other moneys payable to the county by any department or agency of the state.

Report continues with Finding 8 on next page.



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**Finding 8: KRS has \$16.1 Million in Delinquent Balances**

KRS is the only Kentucky retirement system with significant delinquent account balances. As of April 15, 2019, KRS's delinquent account balance totaled approximately \$16.1 million. This includes a delinquent balance of over \$9 million for payout of standard sick leave, \$2.9 million for pension spiking, \$1.9 million for Health Insurance Reimbursement, and almost \$1.7 million for standard monthly reporting invoices. In addition, state statutes do not allow KRS to charge late reporting penalties to all employers and state agencies.

**Late Reporting Penalties**

Kentucky Revised Statute 78.625(3) states “If an agency is delinquent in the payment of contributions due in accordance with any of the provision of KRS 78.510 to 78.852, refunds and retirement allowance payments to members of this agency may be suspended until the delinquent contributions, with interest at the rate adopted by the board compounded annually, or penalties have been paid to the system.” KRS management confirmed that Kentucky Revised Statute 78.625(3) has never been used to suspend refund and retirement allowance payments for CERS members. Also, KRS stated there is no specific statutory language in which refunds and retirement allowance payments to members can be suspended in KERS for non-payment.

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KRS 78.625(3) has never been used to suspend refund and retirement allowance payments for CERS members.

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As previously noted, 677 employers either submitted their information on time and were not charged a monthly reporting penalty, or they are considered ‘integral’ to the executive branch and therefore, wouldn’t be charged a monthly reporting penalty. The four agencies noted below with a high amount of outstanding invoices are not being charged monthly reporting penalties. KRS considers these agencies to be ‘integral’ to the executive branch, which is why they are not charged the late reporting penalty. According to KRS, integral agencies are defined per Kentucky Revised Statute 12.020. While the statute lists a number of “departments, program cabinets, and administrative bodies,” this statute does not provide any definition for the term “integral.” This statute excludes counties and cities, as such, these are the primary employers charged the \$1,000 fee by KRS for late reporting.

House Bill 519 from the 2004 Regular Session increased the delinquent penalty amount from \$100 to \$1,000. KRS personnel believe the system last requested an increase in the penalty amount charged to employers in 2016, but it was not approved.

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## Delinquencies

In addition to penalties for late reporting, KRS deals with non-compliance as it pertains to payment of invoices. An employer is delinquent when it has not paid its monthly invoice. See Appendix E for a list of the types of invoices processed by KRS and a brief description of each type.

As of April 15, 2019, KRS had \$16,105,245 in outstanding, unpaid invoices. This is a 70% increase since the end of FY 2018. The top four invoice types with the highest unpaid invoice amount included Standard Sick Leave (\$9,150,702), Pension Spiking (\$2,911,978), Health Insurance Reimbursement (\$1,940,521), and Monthly Reporting Invoice (\$1,668,565). The top four employers with the highest unpaid balances included:

- Kentucky State Police – \$6,108,849
- Kentucky Personnel Cabinet – \$1,449,082<sup>1</sup>
- Department of Corrections – \$1,078,978
- Department of Highways – \$641,962

KRS management stated these are larger agencies with a small number of staff trained on retirement reporting. If turnover occurs at the agency level then this extends the time to receive payment until proper training is given to the new employee. KRS speculates employers may believe future legislative action will forgive outstanding invoices.

KRS presented to its Audit Committee and Board of Trustees several potential ways to address the non-payment of outstanding invoices. These options include involuntary cessation, suspension of service credit for active members, and stopping retiree payments. Involuntary cessation, where an employer is forced out of the retirement system until the balance is paid, would require legislation. KRS has never suspended service credit or stopped a retiree's payments due to non-compliance.

Employer pension spiking is the only invoice type that state law allows the system to charge interest for non-payment. While state law allows the system to penalize the employer for pension spiking, it postpones charging interest to employers. Per 105 KAR 1:140 Section 7(11), for members retiring on or after January 1, 2014, but prior to July 1, 2017, in which pension spiking has occurred, "the employer may request that the retirement systems allow the employer to pay the cost over a period, not to exceed one (1) year, without interest and the retirement systems shall establish a payment plan for the employer." After one year, if the pension spiking invoice has not been paid, then KRS begins charging the employer interest which is compounded monthly.

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<sup>1</sup> Delinquency balance for Kentucky Personnel Cabinet is not considered a true delinquency by KRS as this amount represents the variances in monthly reporting from the Personnel Cabinet dating back to 2011 when the Kentucky Human Resource Information System (KHRIS), the State's payroll system, was implemented. The discrepancies are primarily due to payroll adjustment issues with KHRIS.

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KRS staff informed auditors that a “payment plan” of multiple installment payments is not actually created by KRS’ Employer Reporting, Compliance, and Education (ERCE); the only changes made to an invoice after the 12-month delay is when interest is applied. The Strategic Technology Advancements for the Retirement of Tomorrow (START) technical documentation associated with pension spiking identified that the KRS design team “will build this functionality with an eye toward being able to apply the billing of interest on other employer invoices in the future.” START is the computer system used by KRS to process all retirement related benefits.

### **Policy/Procedure**

KRS did not have formal policies or procedures over processing late filed submissions or enforcing penalties during FY 2018. Therefore, there was no consistency in the way different KRS reporting teams handle penalties. During the APA’s FY 2018 financial audit of KRS, auditors found that KRS had no written policies for waiving penalties. APA financial auditors also noted there was no statutory authority to waive penalties. As previously noted, 2019 House Bill 80 changed the language of Kentucky Revised Statutes 61.675 and 78.625 to give KRS discretion when applying penalties, but procedures have still not been developed to govern when KRS charges or waives a penalty. The creation of formal, written policies and procedures was recommended by APA auditors in December 2018, and KRS management agreed that such policies would be adopted.

As of September 2018, the Outstanding Invoice Focus Project was drafted and implemented by KRS. As part of this project, ERCE will specifically target all outstanding Pension Spiking and Sick Leave invoices since these invoice types represent the majority of the outstanding invoices. This plan states that after 120 days, if no progress has been made in regards to collection of an outstanding invoice, ERCE will contact the KRS Legal team for further action. The ERCE will work jointly with the KRS Legal team to ensure collection of the outstanding invoices.

The Employer Reporting Manual is outdated and does not reflect the correct interest rate associated with delinquent employer reporting. The manual is dated 2013 and states, “employers who fail to file contributions, detail contribution report and the summary by the 10<sup>th</sup> day of the month will be required to pay interest on the delinquent contributions at the actuarial rate adopted by the Board which is currently 8.00% compounded annually, subject to a minimum amount of \$1,000.” The current actuarial rate adopted by the Board on August 28, 2018 is 7.5%.

### **Recommendations**

We recommend KRS:

- Update its Employer Reporting Manual to ensure it is complete and accurately describes processes and procedures with the correct interest rate used for delinquent invoices. This will allow KRS to properly and consistently fine charges for late monthly reporting.

- Continue to work with the Kentucky Personnel Cabinet to ensure variances identified in the monthly reporting are properly resolved.
- Enable billing of interest in the START system so that it may be applied to all employer invoice types, not just employer pension spiking and configure START to allow employers to establish a payment plan.
- If suitable payment plans cannot be agreed upon, exercise its right to recover monies owed by county employers by taking legal action in Franklin County Circuit Court to begin deducting from any other moneys payable to the county by any department or agency of the state.
- Adopt formal written policies and procedures on waiving penalties. These policies and procedures should be approved by the Board of Trustees, and KRS management should provide the Board of Trustees with a regular report of any penalties waived under this policy.

We recommend the General Assembly:

- Define what “integral” means in the context of Kentucky Revised Statute 61.675 for purposes of determining which employers in the Executive Branch of state government are not subject to penalties for late payments to KRS.
- Consider amending Kentucky Revised Statutes 61.675 and 78.625 to provide for a graduated scale of allowable penalties that increase over time, which will incentivize more timely payments by employers in the event penalties are enforced by KRS.
- Establish legislation allowing KRS to bill interest for all employer invoice types that are not paid within the required timeframe.

Report continues with Chapter VI on next page.

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**CHAPTER VI: BENEFITS TO DECEASED INDIVIDUALS****Finding 9: KRS Paid \$12,611 to Deceased Individuals in FY 2018**

A lack of adequate controls allowed for \$26,045 in overpayments to be paid to deceased individuals, of this amount \$12,611 occurred in FY 2018. Over half of the total overpayments identified were paid to a single member who died 39 months prior to identification by the system. Payments made by KRS to deceased persons require recuperation of overpayment of benefits and create an administrative burden. It is more effective to implement adequate controls to prevent overpayments.

Upon retirement, members of KRS select a retirement option that will provide a monthly benefit and death benefit to a beneficiary of their choosing upon their death. Notification of a member's death prompts the START system to suspend payment of benefits to the member on the first day of the month following the month the death occurred. If notification is received later than the month of death, payments are suspended immediately and recuperation of any overpayment is initiated by KRS.

KRS is notified of an individual's death by various means, including: notification from funeral homes, family members, or employers of the deceased retiree or beneficiary, banks through returned deposit of retirement checks, returned mail, canceled insurance reports, or an interface file with Cabinet for Health and Family Services' (CHFS) Vital Statistics and/or LexisNexis, a national database. The LexisNexis database and CHFS Vital Statistics are essentially used as a failsafe for identifying deaths of individuals receiving benefits from KRS. Vital Statistics identifies all active, retiree, beneficiaries and health insurance dependents who have died in Kentucky while LexisNexis reports deaths throughout the United States. Each month, KRS will send a list of individuals participating in the system to LexisNexis and CHFS to identify any potential matches. Potential matches are returned to KRS for further review and action. Individuals are matched using five fields of information: name, social security number, address, city, and zip code.

Individuals receiving an exact match for all five fields are considered a possible match by KRS and begin processing through START. The LexisNexis report contains other possible matches such as four of five of the fields are an exact match, three of the five fields exact match and a close match in a 4<sup>th</sup> field. An exact match in four of the five fields and a close match in the fifth field, e.g. first name Will versus William, is added to an exception report by KRS. This could also be an instance of an individual's maiden name recorded in one database and married name recorded in another.

Examination of KRS records found one individual was reported as a match in the LexisNexis report in February 2018 and March 2018, but was not considered by KRS as an exact match due to a one day discrepancy in the individual's date of birth. KRS did not research the matter further until April 2018. Through research, KRS found the individual passed away January 2015. As a result, the individual was paid \$463.26 in monthly benefits for 39 consecutive months after death, totaling \$18,067 in over payment. It is not

known why the LexisNexis report did not identify the individual as a match for nearly three years.

From a sample of KRS retirement benefit payments, seven other individuals were found to have received payment after death. Of these associated overpayments, all but one was fully recovered by KRS by October 31, 2018. The remaining overpayment, totaling approximately \$1,608, was recovered by deducting the amount from the \$5,000 death benefit on April 9, 2019. With respect to four of the seven individuals, KRS was not made aware of these deceased retirees by Vital Statistics. These were identified by the APA as part of this examination. As a result, KRS has provided examples to Vital Statistics to explain the issue but had not yet had detailed discussions concerning this issue with the agency as of May 8, 2019. KRS personnel state that they intend to request a year-end report or change the date when they receive the file to the last day of the month. These plans have not been finalized as of May 8, 2019.

### **Recommendation**

We recommend KRS:

- Work with Vital Statistics and LexisNexis to ensure it gets complete and accurate data. The Vital Statistics file contains all deaths reported in Kentucky each month. By December, it contains a comprehensive list of deaths in Kentucky for the entire year. KRS should perform a comparison each month, as well as a comprehensive annual comparison, to ensure they have accounted for all deaths reported by Vital Statistics.
- Consider revising the matching criteria that prompts KRS to perform further research on individuals listed in the LexisNexis file. Besides exact matches, KRS should document what potential matches or criteria will be investigated further.

Report continues with Finding 10 on next page.

### **Finding 10: JFRS Chose Not to Recover Over \$1,300 in Overpayments Made Subsequent to Retirees' Death**

Our review of the JFRS procedures related to retiree benefit payments found that JFRS does not have adequate controls in place to prevent payments to deceased beneficiaries and does not consistently recover retiree benefit overpayments made for deceased retirees. Between July 1, 2017 and August 31, 2018, three out of 18 deceased retirees received a benefit payment after their death. Also, for FY 2017, four out of 20 deceased retirees received a benefit payment after death. In both years, there was no attempt to recuperate the overpayments for these individuals.

Per the “Retirements – Benefit and Health Insurance” portion of the *JFRS Procedures Manual*, benefits to a member terminate on the date of death. Additionally, benefits to a qualified survivor commence on the day following the date of death and are proportionately made to the retiree/survivor. To calculate the benefits owed to the retiree and survivor, a daily rate is calculated and applied. For instance, if a retiree dies on September 6, the final payment to the retiree will represent payment for the period September 1 through September 6, and the survivor’s benefit will be for the period September 7 through September 30. Thus, any payments made to the deceased individual beyond the date of death are not in compliance with the procedures manual.

Additionally, the “System and Fund Accounts” portion of the *JFRS Procedures Manual* states the following:

Notification of the death of a recipient of benefits, after the processing of the check writer file but before the actual transfer of the funds, necessitates the filing of a *Deletion, Reversal, Reclaim Request* with the State Treasury. If the reversal is not successful, a letter is written to the recipient’s estate to request repayment of a possible overpayment.

JFRS does not have any control procedures in place to identify deceased members or beneficiaries. A Certificate of Death is not required by JFRS to process a death request. The most common method of notification is when the obituary is printed in the newspaper. The JFRS Executive Director acknowledged that she typically attends the funerals for any deceased member. JFRS is also notified of deaths when the surviving beneficiary or spouse calls to report the death, when the deceased member’s health insurance is canceled, or when the bank account is closed and the electronic funds are rejected and returned. Unlike the other two Kentucky retirement systems (TRS and KRS), JFRS does not use data from Vital Statistics or an outside vendor to assist with identifying deceased members.

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JFRS does not require a Certificate of Death to process a death request.

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There is no policy or criteria regarding waiver of overpayment of benefits to deceased individuals. The Executive Director makes the decision based on the amount of the overpayment, the number of days represented by the overpayment, and the potential cost to recoup the overpayment. However, there is no defined timeframe, specific dollar amount, or percentage threshold when making the determination to recoup overpayments. The decision to recover retiree benefit overpayments rests solely with, and is made at the discretion of, the Executive Director of JFRS in practice. This authority is not stated in the written procedures manual. The Board of Trustees is not involved in any capacity with the decision to recoup overpayments.

Unrecovered overpayments are an unnecessary and unordinary expenditure for JFRS. For FYs 2017 and the period July 1, 2017 through August 31, 2018, the overpayments were approximately \$385 and \$967, respectively. The amount of the overpayments ranged from \$51.54 to \$748.26 per individual.

### **Recommendation**

We recommend JFRS:

- Require a Certificate of Death prior to processing a deceased member or beneficiary request. JFRS should also consider requesting a list of deceased individuals from Vital Statistics or an external vendor and performing a data match on a regular basis to ensure all deceased members and beneficiaries are properly identified. This process should be thoroughly documented in the JFRS Procedures Manual.
- Follow its procedures manual regarding ceasing benefits on the date of death for all deceased retiree benefit payments. Furthermore, JFRS should follow the manual regarding requesting the overpayments. If an overpayment is identified before the payment has been completed, then JFRS should fill out the appropriate forms to request the reversal of the payment. If the overpayment occurs after the payment has been successfully paid to the deceased retiree, a written request should be made to the estate requesting repayment.



**APPENDICES**

Appendix A: Sample KRS Letter to Investment Manager



**KENTUCKY RETIREMENT SYSTEMS**

David L. Eager, Interim Executive Director  
Perimeter Park West • 1200 Louisville Road • Frankfort, Kentucky 40601  
kyrrt.ky.gov • Phone: 502-696-8800 • Fax: 502-696-8822



July 10, 2017

Anchorage Capital  
Attn: Kate Hechinger  
610 Broadway  
6<sup>th</sup> Floor  
New York, NY 10012

Dear Ms. Hechinger:

Kentucky Retirement Systems ("Kentucky Retirement") would like to express its appreciation for the working relationship it has had with you. I write to provide an update regarding the statutes governing Kentucky Retirement's investment of fund assets and to enlist your help so that the agency may comply with new statutory provisions. During its 2017 regular session, the Kentucky General Assembly passed Senate Bill 2, which amended several important provisions governing the Kentucky Retirement Systems.

**A. Senate Bill 2 requires compliance with certain CFA Codes.**

Senate Bill 2 amended KRS 61.650(1) to provide:

(d) In addition to the standards of conduct prescribed by paragraph (c) of this subsection, all individuals associated with the investment and management of retirement system assets, whether contracted investment advisors, board members, or staff employees, shall adhere to "The Code of Ethics and Standards of Professional Conduct," the "Asset Manager Code of Professional Conduct" if the individual is managing retirement system assets, and the "Code of Conduct for Members of a Pension Scheme Governing Body" if the individual is a board member. All codes cited in this paragraph are promulgated by the CFA Institute.

In connection your relationship with Kentucky Retirement Systems, you must comply with Kentucky Revised Statutes Section 61.650(d) to the extent applicable under Kentucky law. (For the avoidance of doubt, this requirement encompasses each partnership (or other entity in which KRS invests) as well as its manager, general partner, and associated individuals with management authority.)

**B. Contracts or offering documents for services, goods, or property purchased by Kentucky Retirement must be posted to the systems' website.**

In its efforts to increase transparency, Senate Bill 2 also requires that "contracts or offering documents for services, goods, or property purchased or utilized by the system," be made available

on Kentucky Retirement's website. To comply with this requirement, Kentucky Retirement intends to post its contracts and offering documents to its website. (Offering documents are disclosed once the offering period has expired, to avoid securities law violations.)

To aid Kentucky Retirement Systems in complying with the statutory requirements in Senate Bill 2, please provide redacted versions of the relevant partnership agreements, contracts, or other documents that may be posted to Kentucky Retirement's website. Please note that the redactions should be limited to only that information that is proprietary or otherwise exempt from disclosure under Kentucky's Open Records Act, or which if disclosed would harm the systems' ability to competitively invest. (In other words, the redactions must be kept to a minimum, or else the Kentucky Attorney General is likely to reject the redacted document and require disclosure of the full unredacted document.) With those documents, please include a cover letter describing the basis for the redactions made.<sup>1</sup>

After receipt of the proposed redactions and cover letter, Kentucky Retirement will review to determine whether the redactions protect proprietary information; whether the proposed redacted information, if disclosed, would harm Kentucky Retirement's ability to competitively invest; and whether the proposed redactions comply with the exemptions permitted by Kentucky Open Records Act at KRS 61.878. If the redactions are acceptable to Kentucky Retirement, the redacted documents will be posted Kentucky Retirement's website. If Kentucky Retirement has objections to the redactions, it intends to contact you to seek a resolution as to the appropriate scope of redactions in order to avoid posting unredacted materials to its website.

**C. Kentucky Retirement must request certain information from all managers, partnerships, and any other available sources and disclose that information on its website.**

In addition to the requirements outlined above, Senate Bill 2 requires that KRS request certain information and that the requested information be disclosed on the systems' website. Senate Bill 2 amended KRS 61.645(19)(i) to require that Kentucky Retirement post certain information to its website and shall make available to the public:

All investment holdings in aggregate, fees, and commissions for each fund administered by the board, which shall be updated on a quarterly basis for fiscal years beginning on or after July 1, 2017. The systems shall request from all

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<sup>1</sup> The basis for redaction could invoke the exception to disclosure for "records confidentially disclosed to an agency or required by an agency to be disclosed to it, generally recognized as confidential or proprietary, which if openly disclosed would permit an unfair commercial advantage to competitors of the entity that disclosed the records." See Kentucky Revised Statutes section 61.878(1)(c)(1). Fee terms, however, are expressly required to be disclosed, and may not be redacted.

managers, partnerships, and any other available sources all information regarding fees and commissions and shall, based on the requested information received:

1. Disclose the dollar value of fees and commissions paid to each individual manager or partnership;
2. Disclose the dollar value of any profit sharing, carried interest, or any other partnership incentive arrangements, partnership agreements, or any other partnership expenses received by or paid to each manager or partnership; and
3. As applicable, report each fee or commission by manager or partnership consistent with standards established by the Institutional Limited Partners Association (ILPA).

In addition to the requirements of this paragraph, the systems shall also disclose the name and address of all individual underlying managers or partners in any fund of funds in which system assets are invested;

In addition, pursuant to KRS 61.645(19)(j), Kentucky Retirement must disclose:

An update of net of fees investment returns, asset allocations, and the performance of the funds against benchmarks adopted by the board for each fund, for each asset class administered by the board, and for each manager. The update shall be posted on a quarterly basis for fiscal years beginning on or after July 1, 2017;

Please consider this as Kentucky Retirement's request that you provide the relevant information outlined above on a quarterly basis. Your cooperation will aid Kentucky Retirement in meeting its statutory duty to publicly and timely disclose this information.

**D. No Kentucky Retirement Systems funds may be used to pay fees and commissions to placement agents.**

Finally, for your reference, please note that Senate Bill 2 also amended KRS 61.645(1) to provide:

Notwithstanding any other provision of KRS 16.505 to 16.652, 61.510 to 61.705, and 78.510 to 78.852 to the contrary, no funds of the systems administered by Kentucky Retirement Systems, including fees and commissions paid to an investment manager, private fund, or company issuing securities, who manages systems assets, shall be used to pay fees and commissions to placement agents. For

purposes of this subsection, "placement agent" means a third-party individual, who is not an employee, or firm, wholly or partially owned by the entity being hired, who solicits investments on behalf of an investment manager, private fund, or company issuing securities.

I look forward to receiving redacted versions of the legal documents related to our investment with you, as well as affirmations of compliance with the other requirements outlined in this letter. I sincerely appreciate your cooperation as Kentucky Retirement complies with the provisions of Senate Bill 2.

If I do not hear from you within a reasonable time, Kentucky Retirement will have no choice but to comply with Senate Bill 2, which requires it to post on its website copies of all of the unredacted contracts which we have in our files with you (including all offering materials). If you have any questions, please do not hesitate to contact me.

Sincerely,

Richard Robben, CFA  
Chief Investment Office  
502-696-8642

Appendix B: Sample KRS Contract Language

13.2 **Confidentiality.**

13.2.1 *Public Records.*

(a) To the fullest extent permitted by law, each Limited Partner agrees to keep confidential, and not to make any use of (other than for purposes reasonably related to its interest in the Partnership or for purposes of filing such Limited Partner's tax returns) or disclose to any person, any Confidential Information or matter relating to the Partnership and its affairs and any confidential information or matter related to any investment of the Partnership, other than disclosure to such Limited Partner's directors, employees, agents, lawyers, auditors, administrators or other representatives or advisors for purposes reasonably related to such Partner's investment in the Partnership or to any other person approved in writing by the General Partner (each such person being hereinafter referred to as an "**Authorized Representative**"). Notwithstanding anything in this Agreement to the contrary and notwithstanding Section 17-305 of the Act, any information to be provided or disclosed to one or more Limited Partners may be limited or adjusted, in the General Partner's sole discretion, such that the data that identifies or otherwise relates to any other Partner need not be disclosed to such Limited Partners. Each Limited Partner acknowledges and agrees that the Confidential Information shall be deemed non-public, confidential and proprietary in nature and shall constitute trade secrets under applicable law with respect to the Partnership, its Portfolio Companies and Investments and the General Partner, the Investment Manager and their Affiliates, the disclosure of which could have an adverse effect on the Partnership, its Portfolio Companies or Investments, the General Partner, the Investment Manager or their Affiliates. In furtherance hereof the General Partner shall have the right to keep

confidential from one or more Limited Partners for such period of time as the General Partner deems reasonable, any Confidential Information which the General Partner reasonably believes to be in the nature of trade secrets or other information the disclosure of which the General Partner in good faith believes is not in the best interests of the Partnership, its Portfolio Companies or Investments, or the General Partner or its Affiliates or any of their respective businesses or could have an adverse effect on any of the foregoing or which the Partnership or the General Partner is required by law or by agreement with a third party to keep confidential. If any Partner or any Authorized Representative of such Partner is required to disclose any of the Confidential Information, such Partner will use commercially reasonable efforts to provide the Partnership with prompt written notice so that the Partnership, the Partner or any issuer with respect to any Investment may seek a protective order or other appropriate remedy and/or waive compliance with the provisions of this Agreement, and such Partner will use commercially reasonable efforts to cooperate with the Partnership, the Partner or any issuer with respect to any Investment in any effort any such Person undertakes to obtain a protective order or other remedy. If such protective order or other remedy is not obtained or the Partnership or the Partner waives compliance with the provisions of this Section 13.2, such Partner and its Authorized Representatives will furnish only that portion of the Confidential Information that is required and will exercise all reasonable efforts to obtain reasonably reliable assurance that the Confidential Information will be accorded confidential treatment.

(b) Notwithstanding Section 13.2.1(a), the Partnership hereby acknowledges that KRS is a public agency subject to (i) Kentucky's public records law (the "Open Records Act," Kentucky Revised Statutes sections 61.870 to 61.884), which provide generally that all records relating to a public agency's business are open to public inspection and copying unless exempted under the Open Records Act, (ii) Kentucky Revised Statutes section 61.645(19)(i) (the "Fee Disclosure Law"), and (iii) Kentucky Revised Statutes sections 61.645 (19)(l) and (20) (the "Document Disclosure Law"), which provide generally that all contracts or offering documents for services, goods, or property purchased or utilized by KRS shall be made available to the public unless exempted under the Document Disclosure Law. Notwithstanding any provision in this Agreement or the Subscription Agreements to the contrary, the Partnership hereby agrees that (x) KRS will generally treat all information received from the General Partner or the Partnership as open to public inspection under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, unless such information falls within an exemption under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, and (y) KRS will not be deemed to be in violation of any provision of this Agreement or the Subscription Agreements relating to confidentiality if KRS discloses or makes available to the public (e.g., via KRS' website) any information regarding the Partnership to the extent required pursuant to or under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, including the Fund-Level Information described in paragraph (c) below (even if a court or the Attorney General later determines that certain information disclosed by KRS falls within an exemption under the Open Records Act, the Fee Disclosure Law, or the Document Disclosure Law). Notwithstanding the foregoing, such Limited Partner hereby agrees that, in addition to compliance with the notice requirements set forth in this Section 13.2, such Limited Partner (x) shall take reasonable steps to oppose and prevent the requested disclosure unless (i) such Limited Partner is advised by counsel that there exists no reasonable basis on which to oppose such disclosure, (ii) the General Partner does not object in writing to such disclosure within ten days (or such lesser time period as stipulated by the applicable law) of such notice or (iii) such disclosure solely relates to fund level,

aggregate performance information (i.e., aggregate cash flows, overall “IRRs,” the year of formation of the Partnership, and such Limited Partner’s own Capital Commitment) and does not include (A) any information relating to any individual Investment, (B) unredacted copies of this Agreement and related documents or (C) any other information not referred to in clause (iii) above, and (y) acknowledges and agrees that notwithstanding any other provision of this Agreement, the General Partner may in order to prevent any such potential disclosure that the General Partner determines, in its sole discretion, is likely to occur withhold all or any part of the information otherwise to be provided to such Limited Partner other than the fund level, aggregate performance information specified in clause (iii) above and any tax information, unless disclosure of such information can be made in non-reproducible, non-downloadable or other manner and format reasonably acceptable to the General Partner such that such information would not be subject to potential disclosure under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law, or any similar statutory or regulatory requirements.

(c) The General Partner acknowledges that KRS considers certain fund-level information public under the Open Records Act, the Fee Disclosure Law or the Document Disclosure Law and that KRS has concluded that it is obligated to disclose such information upon request (e.g., via KRS’ website). Notwithstanding any provision in this Agreement or Subscription Agreements to the contrary, the General Partner agrees that KRS may disclose the following information without notice to the General Partner or the Partnership: (i) the name of the Partnership, (ii) the vintage year of the Partnership and/or the date in which KRS’ initial investment was made in the Partnership, (iii) the amount of the KRS’ Capital Commitment and Unfunded Capital Commitment, (iv) aggregate funded contributions made by KRS and aggregate distributions received by KRS from the Partnership as of a specified date; (v) the estimated current value of KRS’ investment in the Partnership as of any previous date, (vi) the net asset value of the Partnership as of a specified date, (vii) the estimated IRR of KRS’ investment in the Partnership as of a specified date, which shall be clearly disclosed to have been calculated by KRS or its representatives and not to have been provided or approved by the General Partner or the Partnership, and (viii) the amount of fees and commissions (including, but not limited to, the Management Fees and Incentive Allocations) paid to the General Partner, Investment Manager and its Affiliates with respect to KRS’ interests (the “Fund-Level Information”).

(d) The General Partner agrees that KRS may disclose redacted versions of this Agreement and KRS’ Subscription Agreements, in each case to the extent required by the Document Disclosure Law, once the offering period ends and KRS’ Closing occurs on December 20, 2017.

(e) Notwithstanding any provision in this Agreement or Subscription Agreements to the contrary, the General Partner shall provide KRS on at least a quarterly basis (i) the dollar value of fees and commissions paid by KRS (including via Capital Contributions) to the Partnership (including any alternative investment vehicle), the General Partner, the Investment Manager or their respective Affiliates; and (ii) the dollar value of KRS’ pro rata share of any Incentive Allocations paid to the General Partner.

(f) The General Partner agrees that KRS may disclose confidential information to any governmental body that has oversight over it and its statutory auditor, without



notice to the General Partner or the Partnership; provided that such information retains the same confidential treatment with the recipient.

(g) The General Partner agrees to provide reporting to KRS in accordance with the Fee Template published by the Institutional Limited Partners Association (available at [ilpa.org](http://ilpa.org)).

13.2.2 *CFA Standards*. In connection with KRS' investment in the Partnership, the General Partner shall not take any action that is inconsistent with Kentucky Revised Statutes Section 61.650(1)(d) to the extent applicable.

13.2.3 Neither the General Partner nor the Partnership shall disclose any confidential information regarding any Limited Partner; provided that the General Partner or the Partnership may make such disclosure to the extent that (i) the information to be disclosed is publicly known at the time of proposed disclosure by the General Partner or the Partnership, (ii) the information otherwise is or becomes legally known to the General Partner or the Partnership other than through disclosure by a Limited Partner, or (iii) such disclosure is required by law or in response to any governmental agency request or in connection with an examination by any regulatory authorities

Appendix C: Redacted Version of Appendix B as presented on KRS website

13.2 **Confidentiality.**

13.2.1 *Public Records.*

(a) To the fullest extent permitted by law, each Limited Partner agrees to keep confidential, and not to make any use of (other than for purposes reasonably related to its interest in the Partnership or for purposes of filing such Limited Partner's tax returns) or disclose to any person, any Confidential Information or matter relating to the Partnership and its affairs and any confidential information or matter related to any investment of the Partnership, other than disclosure to such Limited Partner's directors, employees, agents, lawyers, auditors, administrators or other representatives or advisors for purposes reasonably related to such Partner's investment in the Partnership or to any other person approved in writing by the General Partner (each such person being hereinafter referred to as an "**Authorized Representative**"). Notwithstanding anything in this Agreement to the contrary and notwithstanding Section 17-305 of the Act, any information to be provided or disclosed to one or more Limited Partners may be limited or adjusted, in the General Partner's sole discretion, such that the data that identifies or otherwise relates to any other Partner need not be disclosed to such Limited Partners.

(b) Notwithstanding Section 13.2.1(a), the Partnership hereby acknowledges that KRS is a public agency subject to (i) Kentucky's public records law (the "**Open Records Act**," Kentucky Revised Statutes sections 61.870 to 61.884), which provide generally that all records relating to a public agency's business are open to public inspection and copying unless exempted under the Open Records Act, (ii) Kentucky Revised Statutes section 61.645(19)(i) (the "**Fee Disclosure Law**"), and (iii) Kentucky Revised Statutes sections 61.645 (19)(l) and (20) (the "**Document Disclosure Law**"),

(d) The General Partner agrees that KRS may disclose redacted versions of this Agreement and KRS' Subscription Agreement



Appendix D: Sample TRS Letter to Investment Manager, with Attachments



**TEACHERS' RETIREMENT SYSTEM**  
of the State of Kentucky

GARY L. HARBIN, CPA  
*Executive Secretary*

TOM SIDEREWICZ, CFA  
*Chief Investment Officer*

Mr. Tom Landry  
c/o TA Realty  
28 State Street, 10<sup>th</sup> Floor  
Boston, MA 02109

October 26, 2017

Re: The Realty Associates Fund X - Pension  
The Realty Associates Fund XI – Pension and Medical Trust

Dear Tom;

TRS, as an agency of state government, must be fully compliant with the both Kentucky Open Records Act as set forth in KRS 61.870 through 61.884, as well as its own statute [KRS 161.250(4) and (5)], which requires the disclosure of certain documents. The latter requirement has new provisions that were established with the enactment of Senate Bill 2 by the Kentucky legislature during the 2017 regular session. This bill, in part, requires TRS to post on its website, and to produce upon request, many items that you have in the past expressed to TRS were considered proprietary and confidential by your firm and that could cause great economic harm to your firm if disseminated so that your competitors would have access to it.

As a state agency, TRS must follow faithfully the letter of the law. However, the Kentucky legislature, recognizing that some documents, if disclosed, could result in economic harm to private companies, has provided for exceptions for certain information under both the Kentucky Open Records Act. Specifically, information that is generally recognized as confidential and proprietary that if disclosed would provide an unfair commercial advantage to competitors is excepted under KRS 61.878(1)(c)1 of the Open Records Act.

This exception is reiterated, and somewhat qualified, under KRS 161.250(5) which, in part, requires the disclosure of otherwise excepted information to the Kentucky State Auditor of Public Accounts, Kentucky's Government Contract Review Committee, and further requires disclosure of any information regarding investment fees and expenses that are required to be disclosed under KRS 161.250. Furthermore, if any public records contain material which is not excepted from disclosure, the excepted material shall be separated by removal, segregation, or redaction, and the non-excepted material shall be disclosed.

There is great deal of complexity and competitiveness in the private equity world. TRS understands that it does not have the background or knowledge to identify in all cases information which could be used by competitors to your disadvantage. As such, TRS would ask your assistance in identifying information that meets the exceptions of the statutes cited in this



letter, and to assist in removing, segregating, or redacting non-expected material from the expected material.

The new requirements of KRS 161.250(4) and (5) mandate that non-expected information be posted on the TRS website by November 15, 2017. Accordingly, TRS would ask for your response by November 14<sup>th</sup>.

Also, attached is a page with information that TRS understands is clearly not expected and will be posted to the TRS website on a quarterly basis. The information on this page is high level and is currently provided by TRS in response to all open records requests. It is information that per our side letters TRS may share.

TRS values our relationship with your firm and appreciate all the hard work you do for your Limited Partners. If you have any question please do not hesitate to contact me at the number below.

Regards,



Karen Ashby, CFA  
Director, Alternative Investments  
Teachers' Retirement System  
477 Versailles Road  
Frankfort, Kentucky 40601  
(502) 848-8607  
Karen.ashby@trs.ky.gov

**Investment Summary**

6/30/2017

**Kentucky Teachers' Retirement System**  
**The Realty Associates Fund X, L.P.**

All Portfolio Investments  
Base Currency: USD

**Investment Description:**

Vintage Year: 2012  
Rank:  
Fund Size: 1,000,000,000  
Ownership %: 5.00 %  
Percent Funded: 100.00 %

Investment Type: Value Add  
Asset Class: Real Estate  
Lead Investment Officer:  
Closing Date: 9/28/2012  
Initial Transaction Date: 9/30/2012

Commitment	Funding	Additional Fees	Cumulative Distributions	Adjusted Valuation	IRR	Multiple of Cost
50,000,000	46,632,121	3,367,879	27,309,791	43,317,057	12.43	1.41

Asset Notes: None



**Investment Summary**

6/30/2017

**Kentucky Teachers' Retirement System**  
The Realty Associates Fund XI

All Portfolio Investments  
Base Currency: USD

**Investment Description:**

Vintage Year: 2016  
Rank:  
Fund Size: 1,000,000,000  
Ownership %: 5.00 %  
Percent Funded: 40.00 %

Investment Type: Value Add  
Asset Class: Real Estate  
Lead Investment Officer:  
Closing Date: 6/30/2015  
Initial Transaction Date: 5/25/2016

Commitment	Funding	Additional Fees	Cumulative Distributions	Adjusted Valuation	IRR	Multiple of Cost
50,000,000	19,326,142	673,858	40,840	19,886,098	(0.51)	1.00

Asset Notes: None

Appendix E: List of KRS Invoice Types, with Brief Descriptions.

**Averaging Refund to Employer** - Returns contributions on members who do not average over the calendar year or fiscal year.

**Employer Purchase of Delayed** - Bills employers the cost of the purchase of delayed service credit by an employer on behalf of a member.

**Employer Purchase of Hazardous Conversion** - Bills employers the cost of the purchase of hazardous conversion by an employer on behalf of a member.

**Employer Free Military and Decompression Service** - Bills the employer for the cost of the employer contributions and awards service credit for a member's time on active military duty.

**Expense Allowance** - Bills for the employer contributions due on the expense allowance paid to each county judge, sheriff, and jailer by a state agency.

**Health Insurance Reimbursement** - Bills employers for reimbursement of health insurance premiums for those members who are reported in the Retired Re-employed contribution group and the member is covered under KRS provided health insurance.

**IPS Employer Refund** - Returns contributions after an IPS review process is completed on a paid contract and an overpayment is determined to have been received.

**Monthly Reporting** - Reflects the result of any variances from the balancing process and any contribution differences from the adjustment and error correction process.

**Omitted Employer** - Bills for employer contributions due to a member's period of employment that was erroneously omitted from monthly reporting.

**Penalty – EOY** - Reflects the penalty assessed for late reporting of the school board end of year file.

**Penalty – Monthly Reporting** - Reflects the penalty assessed for late reporting of monthly reporting.

**Reinstatement** - Reflects adjustments processed for board or court ordered reinstatement periods.

**Standard Sick Leave** - Bills employers for the cost of the unused sick leave balance for individual members only if the employer participates in the Standard Sick Leave program.

Source: APA Based on KRS Employer Reporting Manual.

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**JFRS'S RESPONSE TO REPORT**

**Kentucky Judicial Form Retirement System**

JUDICIAL RETIREMENT PLAN  
LEGISLATORS RETIREMENT PLAN

John R. Grise  
Chairman, Board of Trustees

Donna S. Early  
Executive Director

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August 20, 2019

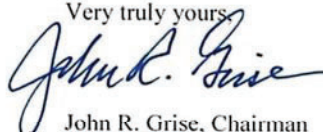
Honorable Mike Harmon  
Auditor of Public Accounts  
Commonwealth of Kentucky  
209 St. Clair Street  
Frankfort, KY 40601

Dear Auditor Harmon:

This response is on behalf of the Board of Trustees of the Judicial Form Retirement System (JFRS) to your August 2019 *Examination of Certain Policies, Procedures, Controls and Transparency Compliance Activities of Retirement Systems in Kentucky*. In your report, you express concern for a \$385 overpayment of the total JFRS pension payments of \$27.2 million during fiscal year 2017, and a \$967 overpayment of the total JFRS pension payments of \$32.3 million during the period July 1, 2017 through August 31, 2018. The trustees will consider your recommendations at an upcoming board meeting.

Thank you for your opinion.

Very truly yours,



John R. Grise, Chairman  
Board of Trustees

JRG/lcy

## KRS's RESPONSE TO REPORT



### KENTUCKY RETIREMENT SYSTEMS

David L. Eager, Executive Director

Perimeter Park West • 1260 Louisville Road • Frankfort, Kentucky 40601  
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August 21, 2019

Hon. Mike Harmon  
Auditor of Public Accounts  
Commonwealth of Kentucky  
209 St. Clair Street  
Frankfort, KY 40601

RE: Examination of Certain Policies, Procedures, Controls, and Transparency Compliance Activities of Retirement Systems in Kentucky

Dear Auditor Harmon:

Kentucky Retirement Systems (KRS) is responding to Examination of Certain Policies, Procedures, Controls, and Transparency Compliance Activities of Retirement Systems in Kentucky dated August 19, 2019. Below are the KRS Management's responses and planned corrective actions for each finding.

#### **Finding 1: KRS has Abdicated its Responsibility to Abide by the Open Records Act**

##### **KRS Management's Response and Planned Corrective Action**

Kentucky Retirement Systems ("KRS") respectfully disagrees with any assertion that it has abdicated (i.e. formally relinquished its authority) its responsibility under the Open Records Act. KRS has diligently sought compliance with the requirements of 2017 Senate Bill 2 ("SB2") even in the face of industry pressures such as existing managers terminating business rather than complying with the policies mandated by SB2. Kentucky Retirement Systems emphasizes KRS 61.645(20), which maintains that while complying with KRS 61.645(19), KRS is under no obligation to furnish information that is exempt under KRS 61.878 (the Open Records Act) or information that would detrimentally impact KRS' ability to invest. The complete language of the provision is provided below for your convenience.



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Notwithstanding the requirements of subsection (19) of this section, the retirement systems shall not be required to furnish information that is protected under KRS 61.661, **exempt under KRS 61.878, or that, if disclosed, would compromise the retirement systems' ability to competitively invest in real estate or other asset classes**, except that no provision of this section or KRS 61.878 shall exclude disclosure and review of all contracts, including investment contracts, by the board, the Auditor of Public Accounts, and the Government Contract Review Committee established pursuant to KRS 45A.705 or the disclosure of investment fees and commissions as provided by this section. If any public record contains material which is not excepted under this section, the systems **shall separate** the excepted material by removal, segregation, or redaction, and make the nonexcepted material available for examination. (Emphasis added).

Please note that contrary to your assertion, this language does not place “the responsibility of redacting information on the retirement system.” KRS’ sole responsibility is to “separate” or isolate any information it is prohibited from disclosing from the information it can otherwise provide. The methods of separating confidential information include removal, segregation, or redaction. However, there is no affirmative duty placed on KRS to perform the actual redaction just as there would be no responsibility to remove a document containing solely proprietary information. There is no statutory authority prohibiting the individual managers from redacting their “trade secrets.”

Moreover, KRS correctly noted that it “is not in a legal position to determine what an investment manager can or cannot redact.” KRS does not provide legal counsel to the investment managers and is not best situated to make the legal determination as to whether disclosure of certain information “would permit an unfair commercial advantage to competitors” pursuant to KRS 61.878(1)(c). Further, it would be improper based upon the contractual relationship between KRS and its investment managers for KRS to make that determination. It would open KRS up to potential litigation for breach of contract for disclosure of contractually protected confidential proprietary information. KRS can request that investment managers provide detailed explanations of all redactions, but KRS would be unable to vet or object to the determination of the investment managers or otherwise disclose information viewed as proprietary. KRS does not have the discretion to refuse the decision of an investment manager and any disclosure in defiance of the manager’s determination opens KRS up to potential liability.

Regarding the recommendation to seek clarification from the Kentucky Attorney General to define what financial data should be considered proprietary, KRS contends that this determination must occur on a case-by-case basis. A bright line rule or blanket decree as to what should or should not be disclosed would inevitably lead to both the under and over disclosure of information. In addition, KRS 61.880 outlines a process by which any aggrieved party under the Open Records Act can appeal to the Attorney General or directly to the courts. Kentucky Retirement Systems has been a party to such appeals in the past. In 16-ORD-273, the Office of the Attorney General provided the following:



**KENTUCKY RETIREMENT SYSTEMS**

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Since investment services are the essence of KKR Prisma's business, conducted in a competitive field, there is no reason to doubt that such information is generally recognized as confidential or proprietary. Therefore, it was lawful under KRS 61.878(1)(c)1. for KRS to withhold information relating to KKR Prisma's investment strategy. **The same information would likewise be excludable under KRS 61.645(20), by virtue of its being exempt under KRS 61.878 and in light of the compromising effect disclosure would have on KRS' ability to make competitive investments.** (Emphasis added).

KRS respectfully contends that the statement "Proprietary exemptions place KRS in a position of conflict between the external interest of the contractor and the public interest of the average taxpayer" mischaracterizes the relationships at issue. The exemption allows for KRS to disclose all information except that which the manager maintains would provide an unfair competitive advantage to the manager's competitors so that the manager can work most effectively on behalf of the trust. Without such protections for investment managers, KRS would be limited in obtaining managers to benefit the trust, which would be detrimental to the state and its taxpayers. In addition, the release of proprietary information could potentially result in litigation between KRS and the investment manager so that the trust and taxpayers would again be detrimentally impacted. The proprietary exemption allows KRS to do business within the investment industry for the overall benefit of the trust and, as a result, for the benefit of the state and its taxpayers.

Finally, KRS acknowledges the difficulties in complying with SB2 but also the importance of that compliance. When confronted with an issue regarding the CFA Code of Ethics, KRS worked with the General Assembly to obtain the passage of HB489 to assure continued compliance. Non-redacted contracts are provided to the Government Contract Review Committee and other regulatory bodies that would be problematic if made public. In addition, please see the following correction to Figure 2:

	Investments at Fair Value		
	2017	2018	Difference
Total KERS	3,872,824	4,002,003	129,179
Total CERS	12,237,493	12,976,989	739,496
Total SPRS	421,081	446,041	24,960
			-
	16,531,398	17,425,033	893,635



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**Finding 2: KRS Does Not Post Contracts as Required by Senate Bill 2**

**KRS Management's Response and Planned Corrective Action**

This issue was addressed in multiple responses to the APA over the period of review. KRS was contractually obligated to maintain confidentiality of managers that were on-boarded prior to the passage of SB2 in 2017. In addition, the number of contracts shown in Figure 5 is overstated. For example, Figure 5 reports that there are 276 Private Equity missing contracts for the Pension and Insurance funds combined. However, for the two plans, there are 143 Private Equity contracts of which only eight were completed following the passage of SB2. As of August 13, 2019, KRS has 240 contracts with external investment managers. Of the 240 contracts, 197 are not posted online. In addition, 189 were signed prior to the passage of SB2 and should not be subject to the requirements of SB2. These contracts were negotiated by the parties prior to the passage of SB2 and the individual investment managers were not put on notice of the new requirements. Disclosure of these contracts would open up KRS to liability through breach of contractual obligations. Moreover, publication of contracts entered into prior to the passage of SB2 would require KRS to furnish information that “would compromise the retirement systems’ ability to competitively invest in real estate or other asset classes,” which is protected pursuant to KRS 61.645(20).

Because KRS is not privy to auditor’s methodology in tabulating the number of contracts missing from the website, it cannot know how the auditor arrived at the overstatement of missing contracts. The following table displays the accurate number of contracts for each asset class that are not currently posted on-line. Further, the number of contracts is broken down by current asset class allocations, which went into effect July 1, 2018.

	Core Fixed Income	Public Equity	Real Return	Private Equity	Real Estate	Specialty Credit	Absolute Return	Opportunistic	Total
<b>Pension Fund</b>									
Number of Contracts Not Posted Online	0	0	4	69	9	0	13	1	96
<b>Insurance Fund</b>									
Number of Contracts Not Posted Online	0	0	4	74	9	0	13	1	101
<b>Total</b>	<b>0</b>	<b>0</b>	<b>8</b>	<b>143</b>	<b>18</b>	<b>0</b>	<b>26</b>	<b>2</b>	<b>197</b>

Although not required by SB2, KRS will provide a “list of contracts that are considered confidential and proprietary.” Lastly, KRS will post redacted side letters between the Systems and the external manager as recommended.



## KENTUCKY RETIREMENT SYSTEMS

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### **Finding 3: KRS is Not Monitoring its Investment Managers Consistent with its Investment Policy**

#### **KRS Management's Response and Planned Corrective Action**

KRS is aware of this issue and is working towards a solution. Staff shortages and logistical concerns prevent KRS from meeting with its investment managers within the requisite time. However, KRS coordinates with its investment consultant, Wilshire, who meets routinely with and has ongoing communications with many of our investment managers on our behalf. Regarding the recommendation to decrease the number of investment contracts, KRS notes that it is reducing the number of contracts with private equity managers per the recommendation.

### **Finding 6: KRS Was Unable to Recalculate One Investment Manager's Fees During FY 2018 Due to a Lack of Information and Understanding of the Fee Calculation**

#### **KRS Management's Response and Planned Corrective Action**

KRS concurs with the recommendation. KRS Investment Operations ("Operations") is a relatively new division with a number of new employees. The division has worked hard to ensure all managers' accounts and fees are reconciled in a timely manner. Some manager fees are more difficult to calculate than others depending on the complexity of the fee structure, which is the case in this singular instance. The manager fee in question incorporates a high water mark (HWM) and hurdle rate, which requires additional data to calculate. While Operations staff had not been fully trained on the fee calculation using high water mark or hurdle rates, the fee calculation was reviewed by the Director of Alternative Assets, who is familiar with and understands the fee calculation for this manager. The rate calculated by Operations staff exceeded the rate charged by the manager; therefore, the priority of the issue was not high. As KRS moves forward, we will ensure staff is trained on the calculation of fees upon the hiring of the manager.

### **Finding 7: TRS Uses Fee Caps in Some Contracts; KRS Does Not**

#### **KRS Management's Response and Planned Corrective Action**

KRS is willing to consider the recommendation where appropriate. However, KRS maintains that the following quote regarding TRS' contracts has been misinterpreted. "TRS reserves the authority to adjust quarterly billing and payments if an unusually large amount of annual cap would be paid prior to the 4th quarter of the fiscal year.' This allows TRS to smooth the quarterly payments to a manager so as not to pay more than allowed by the contract." KRS' interpretation of this language is that TRS "reserves the authority" to delay fee payments from one quarter to the





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next, but does not “cap” the annual fee, per se, and, therefore, does not reduce total annual fees. Delaying payment may also affect performance if fees are not reported in the period in which they are incurred.

KRS respectfully notes that figure 7 in the APA’s examination is not accurate. The auditor neglected to include that KRS does include “Custodian [sic] Fees” and “Legal & Research” in its CAFR, which can be found on pages 137 and 104, respectively. KRS also emphasizes that the auditor addresses transparency of fees on the following page, but does not state that KRS reports all investment related fees as reported by BNY Mellon and external managers.

### **Finding 8: KRS has \$16.1 Million in Delinquent Balances**

#### **KRS Management’s Response and Planned Corrective Action**

KRS partially concurs with the findings and recommendations. The Employer Reporting, Compliance and Education (ERCE) division is currently working with the Communications division to update the Employer Reporting Manual to accurately reflect the current processes and procedures. The actuarial rate adopted by the Board was updated in START after the change took place in August 2018. Therefore, START has been properly and consistently charging the correct amount on late monthly reporting penalties.

KRS continues to work with Personnel to resolve reporting variances. Several staff members from both KRS and Personnel have worked extensively on resolving missing final IPS payments. Consequently, the list of delinquent IPS monies has significantly decreased and minimized the reporting variance. KRS and Personnel have also worked together to clear up Personnel’s outstanding pending transactions. In addition, KRS has created a new internal process to identify missing IPS records affecting the report variance so these records can be corrected at the time of our balancing process.

The recommendation suggests KRS should enable billing of interest in the START system so that it may be applied to all employer invoice types. This process will require legislation since there are no statutes that give KRS the authority to charge interest on other types of invoices.

As noted, the ERCE division has started the Delinquent Invoice Collection Process. If the employer does not pay the delinquent invoices within 120 days, ERCE then turns the employer over to our legal department to assist with the collection process. At that time the legal department will review the employers’ responses to previous communications to determine if any further demand letters could resolve these actions. After all informal attempts at collection are exhausted, appropriate legal action will be filed in Franklin Circuit Court. After appropriate judgements are obtained legal counsel will seek to garnish or attach all appropriate funds of the delinquent employer.



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KRS has drafted formal policies and procedures regarding the waiver of late monthly reporting penalties. The policies and procedures will be sent to our legal department for review and then to the Board of Trustees for approval.

KRS seeks to clarify the description of the pension spiking issue noted under Chapter V section on delinquencies. The APA report notes in relevant part,

Pension spiking occurs when a state employee or employer attempts to inflate the employee's retirement allowance with raises or positions that are not bona fide promotions or career advancement in the years prior to retirement. Under Kentucky law, the employee's last employer is responsible for paying the additional costs associated with pension spiking.

Kentucky Revised Statute 61.598(5) actually provides that for employees retiring on or after January 1, 2014, but prior to July 1, 2017 the last participating employer shall be required to pay for any additional actuarial costs resulting from annual increases in an employee's creditable compensation greater than ten percent over the employee's last five fiscal years of employment that are not the direct result of a bona fide promotion or career advancement. There is no requirement that there be an intent on the part of the employer to inflate the employee's retirement benefit.

KRS also seeks to clarify the statement in the APA report that:

KRS management revealed KRS has sued Kentucky River Community Care for failure to properly report employees and pay employer and employee contributions. However, this is the only instance where KRS has applied Kentucky Revised Statute 78.625(2)(b), which pertains to CERS.

The litigation against Kentucky River Community Care was brought as a declaratory judgement action seeking to compel Kentucky River to continue to report employees properly. As Kentucky River Community Care participates in the Kentucky Employees Retirement Systems, no action could be brought against them under Kentucky Revised Statute 78.625 which controls agencies participating in the County Employees Retirement Systems.

KRS also seeks to clarify the statement in the APA report that:

KRS presented to its Audit Committee and Board of Trustees several potential ways to address the non-payment of outstanding invoices. These options include involuntary cessation, suspension of service credit for active members, and stopping retiree payments.



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Involuntary cessation, where an employer is forced out of the retirement system until the balance is paid, would require legislation. KRS has never suspended service credit or stopped a retiree's payments due to non-compliance.

Kentucky Revised Statute 61.523(2)(b) allows for involuntary cessation. However, the regulation explaining the involuntary cessation process, 105 KAR 1:147 did not become effective until February 1, 2019.

### **Finding 9: KRS Paid \$12.611 to Deceased Individuals in FY 2018**

#### **KRS Management's Response and Planned Corrective Action**

KRS agrees with the recommendation to do a comprehensive annual comparison with Vital Statistics. KRS staff are currently working with Vital Statistics to make this update. KRS is already performing a monthly comparison. KRS also agrees to review the matching criteria with LexisNexis and make any needed updates to our procedures.

KRS would like to clarify the file matching process detailed in the third paragraph. KRS only reviews the name, city, and zip code fields to ensure it is in the correct data type (and do not use these fields to match the records). The individuals reported on the file are matched on social security number and date of birth.

Sincerely,

A handwritten signature in black ink, appearing to read "David L. Eager".

David L. Eager  
Executive Director

**TRS'S RESPONSE TO REPORT**



**TEACHERS' RETIREMENT SYSTEM**  
of the State of Kentucky

**GARY L. HARBIN, CPA**  
*Executive Secretary*

**ROBERT B. BARNES, JD**  
*Deputy Executive Secretary*  
*Operations and General Counsel*

**J. ERIC WAMPLER, JD**  
*Deputy Executive Secretary*  
*Finance and Administration*

August 21, 2019

The Honorable Mike Harmon  
Auditor of Public Accounts  
209 St. Clair Street  
Frankfort, KY 40601

Dear Auditor Harmon:

The Teachers' Retirement System of the State of Kentucky (TRS) appreciates the work by the staff of the Auditor of Public Accounts in preparing this report and the opportunity to respond. TRS as an agency of the Commonwealth of Kentucky must comply with state law. TRS has complied with the letter and spirit of Senate Bill 2 (RS 2017) and other applicable laws and sought changes where needed. Therefore, with respect, TRS provides the following responses.

**TRS Response to Finding 4: TRS follows the law consistent with SB 2 regarding contracts and contract information for fund of funds**

SB 2 and the Kentucky Open Records Act support TRS's handling of investment contracts and fund of funds contract information. The law provides separate protections for certain investment information – first, to protect teachers' ability to invest competitively and, second, to protect proprietary investment information. This approach gives teachers access to the best investments to obtain the best returns.

The legislative history of SB 2 confirms TRS's compliance – including as amended by HB 489 (RS 2019), which reaffirmed teachers' ability to invest competitively.

SB 2 as introduced in 2016 did not include protections for information that is proprietary and that allows teachers to invest competitively. TRS advised the sponsor that this effectively would eliminate partnership investments as an asset class. The sponsor revised the bill in the committee substitute, which included the protections and passed the Senate (the bill did not pass the House). The 2017 SB 2 that became law maintained the protections (see KRS 161.250(5) and 61.878) from the 2016 Senate-passed measure.

In 2018, the Public Pension Oversight Board (PPOB) staff reviewed SB 2 compliance. The protections of sensitive information mentioned above were discussed during at least two PPOB meetings that year dealing with the compliance review. Subsequently, the legislature amended SB 2 in 2019 through HB 489, which eliminated an impediment that was causing TRS to be denied access to new partnership investments. That 2019 legislation kept the 2017 law's proprietary and competitive protections.

Letter to Auditor Harmon  
August 21, 2019  
Page Two

Although partnerships account for a large number of overall investment contracts, they are about 11% of the TRS portfolio assets. TRS discloses substantive information about partnership investments (see attachment to Appendix C titled Investment Summary) consistent with Kentucky law. Additionally, TRS follows the common national norms for administering and reporting on partnership investments.

Without the protections reaffirmed by SB 2, TRS's ability to invest in partnerships for the benefit of teachers and taxpayers would be impaired. Teachers would be excluded from an asset class that diversifies their portfolio and has provided some of the best asset class net returns in recent years.

Partnership investments include many partners, including the general partner and numerous limited partners. Each partner has legal duties to the other partners. For one partner to disclose proprietary information unilaterally could breach the contract, harming the value of the investment for all partners and exposing the disclosing partner to penalties.

Disclosing the specific individual underlying managers or partners within a fund of funds investment telegraphs the strategy to everyone, negating its competitive advantage that is the foundation of business.

**TRS Response to Finding 5: TRS follows the law on carried interest consistent with SB 2**

The terms of SB 2 and the Kentucky Open Records Act support TRS's handling of carried interest. The law says certain information about investments may be withheld to protect both teachers' ability to invest competitively and proprietary investment information. This approach gives teachers access to the best investments to obtain the best returns.

Every general partner has asserted that carried interest is proprietary and confidential, the protection of which is a longstanding provision of Kentucky's Open Records Act that SB 2 affirmed. Because of this TRS is not required to report carried interest under SB 2.

If TRS disclosed carried interest, teachers' ability to competitively invest – something the legislature repeatedly has protected – would be impaired because teachers would be excluded from this high-performing asset class.

Carried interest for investments in private equity, real estate, energy, natural resources and infrastructure represents the general partner's share of the partnership's profits. This typically is

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August 21, 2019  
Page Three

20% for the general partner, while 80% of the profits are for limited partners such as TRS. Generally, before the general partner takes profits, limited partners must be paid back their capital investment, interest on the capital investment (e.g., between 7 and 9%) and management fees.

The protections afforded by SB 2 make sense because carried interest is neither a fee nor an expense of TRS – it is the general partner's share of the profits. The profits TRS receives from partnerships are reported in financial reports according to accepted accounting principles. To consider carried interest a fee or an expense would be against generally accepted accounting rules and inflate both investment income and expenses.

TRS reports all fees in aggregate and by manager quarterly and in the CAFR regardless of whether the fees are paid directly from the trust funds or netted against investment income at the partnership level.

For one partner to disclose carried interest unilaterally when the general partner has asserted its confidentiality could breach the contract, exposing the disclosing partner to penalties.

**Other comments and conclusion**

The report discusses TRS's contact with a former staff attorney with the Office of the Attorney General who specialized in open records. In its March 28, 2019, response to the APA, TRS made clear that those contacts were over many years regarding open records issues relating to private equity investment and other matters. That response did not reference SB 2.

TRS reports every dollar paid out of teachers' retirement funds, including investment fees and expenses. So that the fees remain among the lowest in the country and returns remain among the highest in the country for teachers and taxpayers, the formulas behind the fees and other details are not released except as provided by law.

Kentucky's teachers need these partnership investments to diversify and help ensure their retirement security. Disclosing confidential contract terms, such as carried interest, risks potential litigation. Above that cost, the greater damage for teachers and taxpayers would be the exclusion of TRS from future investments in this asset class. These investments are a small but powerful engine producing significant investment income. TRS's private equity portfolio netted 10.18% (preliminary) for fiscal year 2019, which followed net returns of 18.98% in 2018, 9.61% in 2017, 2.7% in 2016, 11.66% in 2015 and 18.55% in 2014. This is part of a gross 10-year return of 13.41%.

Sincerely,



Gary L. Harbin, CPA  
Executive Secretary

## **AUDITOR'S REPLY TO RESPONSES FROM KRS AND TRS**

### **KRS**

The intent of SB 2 was to increase the transparency of the retirement systems and their contracts. The legislature has specifically put this burden on KRS and TRS to maintain that transparency.

KRS disputes the APA's finding that it has "abdicated" its responsibility to abide by the open records act. The key language of Kentucky Revised Statute 61.645(20) states "the systems shall separate the excepted material." Thus, the responsibility for separating this material is placed upon KRS, whether that separation is done by redaction or other means. KRS has voluntarily given up this responsibility by allowing the investment managers to redact as they see fit, which is the very definition of abdicating.

As noted in our report, items such as the name of the vendor, the date of the contract, table of contents headers, and fee terms are clearly not trade secrets. Kentucky Revised Statute 61.645(19) specifically requires disclosure and posting of fees and commissions paid to investment managers.

Information provided in KRS's response regarding the total number of investment contracts that KRS has is not consistent with data provided to the APA by KRS staff on August 13, 2019. KRS has provided the APA with three different numbers when asked for the total number of investment contracts it has. Due to these repeated inconsistencies, it is difficult to have confidence in the information KRS provided pertaining to the number of investment contracts. KRS needs to improve its process for tracking contracts with investment managers, so that it can resolve the discrepancies in the number of contracts reported.

### **TRS**

TRS disagrees with the APA's finding that it does not report carried interest as required by Senate Bill 2. TRS argues that carried interest is exempt from disclosure as proprietary information. However, Kentucky Revised Statute 161.250(4)(i) specifically requires disclosure and posting of "the dollar value of any profit sharing, carried interest, or any other partnership incentive arrangements." That requirement is unambiguous and leaves no room for the interpretation that carried interest is exempt from disclosure.