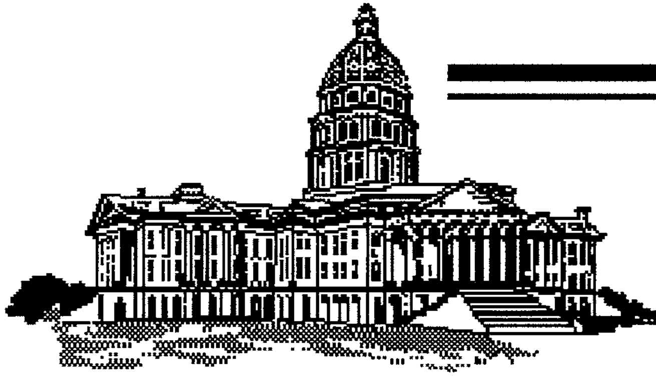

# PERFORMANCE AUDIT REPORT

## Summary Report of Direct Placement Investments And Investment Practices of the Kansas Public Employees Retirement System

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
December 1991

92-40

# Legislative Post Audit Committee

# Legislative Division of Post Audit

**THE LEGISLATIVE POST** Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about $5 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legislators or committees should make their requests for performance audits through the Chairman or any other member of the Committee. Copies of all completed performance audits are available from the Division's office.

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**LEGISLATIVE DIVISION OF POST AUDIT**

1200 Merchants Bank Tower
8th & Jackson
Topeka, Kansas 66612-2212
Telephone (913) 296-3792
FAX (913) 296-4482

# PERFORMANCE AUDIT REPORT

## SUMMARY REPORT OF DIRECT PLACEMENT INVESTMENTS AND INVESTMENT PRACTICES OF THE KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

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### OBTAINING AUDIT INFORMATION

This report summarizes the major findings and recommendations from six audits of the Kansas Public Employees Retirement System. If you need any additional information about the report, please contact Barbara J. Hinton, Legislative Post Auditor, or Leo Hafner, Performance Audit Manager, at the Division's offices.

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# Summary Report of Direct Placement Investments and Investment Practices of the Kansas Public Employees Retirement System

## Summary of Legislative Post Audit's Findings

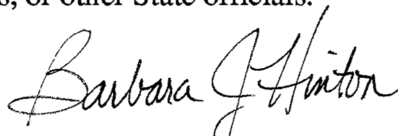
Beginning in fiscal year 1989, the Kansas Public Employees Retirement System began to recognize significant losses from its direct placement investments. Direct placement investments generally are arranged directly with companies whose securities are not publicly traded and involve a higher degree of risk than more traditional investments. In November 1991, the Retirement System's investment managers reported to the Joint Committee on KPERS Investment Practices that, as of November 8, the direct placement portfolio was valued at $164 million, and that $122 million had been written off and $109 million had been put in a reserve to cover future expected losses.

To address legislative concerns about the Retirement System's investment practices and losses, the 1991 Legislature established the Joint Committee on KPERS Investment Practices. To facilitate the Joint Committee's review of the Retirement System, the Legislative Post Audit Committee authorized a series of audits of the Retirement System's investment practices and specific direct placement investments. Through December 1991, this office had completed the following audits of the Retirement System and its direct placement investments:

-- *An Overview of Investment Manager Compensation Practices (June 1991)*
-- *Examining Investments in Tallgrass Technologies, Inc.: Part I (June 1991)*
-- *An Overview of Selected Investment Practices (August 1991)*
-- *Examining Investments in Hydrogen Energy Corporation (August 1991)*
-- *Examining Investments in Tallgrass Technologies, Inc.: Part II (September 1991)*
-- *Examining Investments in the Kansas City Merchandise Mart (December 1991)*

In this series of audits, we have recommended that the Legislature decide whether it wants the Retirement System to continue making direct placement investments. If so, we recommended that the Legislature consider specifying the type and amount of such investments that should be allowed. Given the extent and nature of the problems we identified, however, we have concluded that public employees' retirement funds should not be invested in the types of direct placement investments the Retirement System has made in the past. That conclusion is based on the risky nature of such investments, the potential high cost to the Retirement System of developing an adequate oversight system for such investments, and the potential conflict between Retirement System members' right to know how their moneys are being invested and concerns about negative publicity regarding direct placements.

This report summarizes the major findings and recommendations from the series of audits. Copies of the audit reports are available, by request, from the Division's offices. We would be happy to discuss the report's findings with any legislative committees, individual legislators, or other State officials.



Barbara J. Hinton
Legislative Post Auditor

# Summary Report of Direct Placement Investments And Investment Practices of the Kansas Public Employees Retirement System

Under State law, the Kansas Public Employees Retirement System's Board of Trustees is responsible for managing the Kansas Public Employees Retirement Fund. The Board has delegated its authority to make actual investments to numerous private investment managers under contract with the System. These private investment managers make various types of investments for the System, including direct investments in certain companies.

## The Retirement System Began Allowing Direct Investments In Established Companies in the Mid-1970s, and in Riskier New or Expanding Businesses in the Mid-1980s

Direct placement investments are arranged directly with companies whose securities generally are not publicly traded. These investments may be unsecured, or they may be secured by the company's assets. As a result, they involve a higher degree of risk than more traditional investments such as stock in publicly traded companies. Accordingly, investors demand a higher potential rate of return on these types of investments.

In the mid-1970s, the Retirement System's Board began allowing its investment managers to make direct placements in established companies having an impact on the Kansas economy. The intent was to provide financing to those companies to stimulate job growth and economic development in Kansas. In the mid-1980s, the Board broadened the types of permissible investments to include new or expanding businesses, not just businesses that were ongoing and in sound financial condition. Direct placement investments made since then usually have taken the form of loans or preferred stock convertible into common stock.

## By Late 1991, the Retirement System Had Lost $122 Million On Its Direct Placement Investments, and Another $109 Million Had Been Put In Reserves for Additional Potential Losses

Beginning in fiscal year 1989, the Retirement System began to recognize significant losses from its direct placement investments, peaking with the fiscal year 1991 loss of about $65 million invested in Home Savings Association. In November 1991, the Retirement System's investment managers reported to the Joint Committee on KPERS Investment Practices that, as of November 8, the direct placement portfolio was valued at $164 million, and that $122 million had been written off and $109 million had been put in a reserve to cover future expected losses.

To address legislative concerns about the Retirement System's investment practices and losses, the 1991 Legislature established the Joint Committee on KPERS Investment Practices. Throughout 1991, the Joint Committee has conducted a broad investigation of the Retirement System's investment practices, focusing primarily on direct placement investments. To facilitate the Joint Committee's review, the Legislative Post Audit Committee authorized a series of audits of the Retirement System's investment practices and specific direct placement investments. Through December 1991, this office had completed the following audits of the Retirement System and its direct placement investments:

—*An Overview of Investment Manager Compensation Practices (June 1991)*
—*Examining Investments in Tallgrass Technologies, Inc.: Part I (June 1991)*
—*An Overview of Selected Investment Practices (August 1991)*
—*Examining Investments in Tallgrass Technologies, Inc.: Part II (September 1991)*
—*Examining Investments in the Hydrogen Energy Corporation (August 1991)*
—*Examining Investments in the Kansas City Merchandise Mart (December 1991)*

The purpose of this report is to summarize the major findings and recommendations from this series of audits. As such, this summary report should be viewed in conjunction with the individual reports listed above. Those reports are available upon request from the Division's office. The major findings and recommendations included in the individual reports are summarized in more detail beginning on page six of this report.

**In Responding to These Audits, the Retirement System Reported It Had Made Significant Changes in Its Direct Placement Investment Procedures Since Mid-1991**

The investments we reviewed were initiated in the mid-1980s, and our audits described a significant number of problems with the Retirement System's lack of oversight and monitoring of the investment managers' actions regarding these investments. During 1991, however, a number of existing members of the System's Board of Trustees were replaced with new members, and the System acquired a new Executive Secretary and investment officer. In responding to our audits, the new Executive Secretary generally reported that the System had made significant changes in its direct placement investment procedures since mid-1991, after the investment losses came to light.

In May 1991, the System's Board of Trustees replaced its direct placement managers and placed a moratorium on additional direct placement investments. At that time, the Board also directed its staff to develop and implement a direct placement investment monitoring system. The Board also has determined that the direct placement investment portfolio should be valued every year, and that any resulting

impairments would be recognized in the Retirement System's records. In addition, these annual valuations will be used to calculate investment performance results.

Because many of these changes were implemented recently or were in the process of being implemented during our audits, we generally did not examine those changes to determine whether they adequately addressed the problems identified in our audits. Some changes mentioned by the Retirement System appear to resolve the problems we identified, while others, such as the moratorium on additional direct placement investments, appear to be temporary solutions that will require more permanent action in the future.

## We Have Concluded that Public Employees' Retirement Funds Should Not Be Invested in the Types of Direct Placement Investments the Retirement System Has Been Making

In this series of audits, we have recommended that the Legislature decide whether it wants the Retirement System to continue making direct placement investments. If so, we recommended that the Legislature consider specifying the type and amount of such investments that should be allowed.

Given the extent and nature of the problems we identified, however, we have concluded that public employees' retirement funds should not be invested in the types of direct placement investments the Retirement System has been making. Our conclusion is based on the following:

**These direct placement investments are among the riskiest investments the Retirement System could make.** They include new, expanding, or restructured businesses that are at risk of failing in the event of a downturn in the economy, poor management, unexpected operating costs, a failed research effort, a stagnant market for a product, the loss of key employees or financial backing, or the like.

In the three direct placement investments we reviewed, factors like these played some role in all the failures or downturns these companies experienced. The risk associated with these investments is apparent in light of the staggering losses the Retirement System has experienced. Over time, more than $400 million in Retirement System funds has been invested in direct placement investments. In November 1991, the Retirement System's investment managers reported to the Joint Committee on KPERS Investment Practices that, as of November 8, the direct placement portfolio was valued at $164 million, and that $122 million had been written off and $109 million had been put in a reserve to cover future expected losses.

Kansas' direct placement investments are riskier than the direct placement or venture capital investments made by other states we contacted. For example, Wisconsin's State Investment Board makes direct placements with large, national companies that have publicly traded securities. And the Kentucky Employees Retirement System makes direct placements only in securities guaranteed by the federal government. Venture capital investment funds also can be less risky than the Retirement

System's direct placement investments, because they spread the risk over a pool of investors, and may include many types of companies in different areas of the country.

**Adequate oversight of the System's direct placement investments will likely carry a large price tag that is not justified by the return on past investments of this type.** Recent investigations and several of our audits have focused on investment managers' actions in making direct placement investments. But the underlying responsibility rests with the Board and its staff. Contracting with investment managers to make those investment decisions does not relieve the Retirement System of its oversight responsibilities. Until mid-1991, the Retirement System exercised essentially no oversight of investment managers' actions. Since then, however, the Retirement System has established oversight procedures that attempt to minimize the risk of its direct placement investments.

To provide a level of oversight that is commensurate with the level of risk involved, the System's procedures will be extensive and costly, both in terms of dollars and in terms of the staff's and Board of Trustees' time and effort to monitor direct placement investments. The level of oversight needed for direct placement investments is far greater than that needed for less-risky investments.

To justify the risk and cost of direct placement investments, investors demand a higher potential rate of return. To-date, however, the Retirement System's yield on its direct placement investments has been significantly lower than if it had placed those moneys in such risk-free investments as Treasury bills. In addition, much of the principal has been lost on these investments as well. Based on information provided by the Retirement System about interest and dividends actually received, gains and losses on the sale of investments, write-offs of investments, and related investment fees and expenses, the rates of return on the Retirement System's direct placement portfolio averaged just 2.7 percent per year between July 1986 and March 1991. When additional loss reserves set up during that period for impaired investments are taken into account, that figure drops even lower.

**Although public moneys are being invested, the Retirement System has indicated it does not want some information about its direct placement investments to become public.** For investment instruments that are traded in the marketplace—such as stocks or bonds—their performance can be readily determined and is readily available for public scrutiny. However, because direct placement investments are not publicly traded, the value of those investments cannot be readily determined, and it is not readily available to the public.

In hearings before the Joint Committee on KPERS Investment Practices, the Retirement System's Executive Secretary expressed concerns that, if certain information about direct placements became public, the value of those companies could drop. For example, other potential investors for those companies may be less likely to participate, or potential buyers may be less willing to buy or to pay the asking price.

While that may be true, the Retirement System's concerns need to be balanced with public employees' right to know how their retirement funds are being invested,

and how well those investments are performing. The moneys being invested by investment managers on the Retirement System's behalf belong to both Retirement System members and Kansas taxpayers. Members are required to contribute a portion of their salaries into the Retirement System fund, and a significant amount of State tax dollars are contributed into that fund as well.

Although the Retirement System has taken major steps to make its investment managers more accountable for their actions, the Retirement System's Board and staff cannot be held accountable for investing public moneys unless information about those investments is available to the public. If direct placement investments cannot be made and managed with full public knowledge, we think past experiences with direct placement investments have shown that the public's right to know should prevail.

# Major Findings and Recommendations of the Audits

## An Overview of Investment Manager Compensation Practices
## An Overview of Selected Investment Practices

These two audits primarily examined the Retirement System's practices in such areas as compensating investment professionals, reporting investment values, computing rates of return, monitoring expenses, and overseeing direct placement investments. We also compared the performance and mix of the Retirement System's investment portfolio with other retirement systems' portfolios.

In general, we found the following:

### *Compensating Investment Managers*

1. Direct placement managers had an incentive not to report losses in their investment portfolios. These managers were allowed to set the value of the investments they managed, and were paid based on those values. Not surprisingly, they generally did not report that investments had dropped in value, even when those investments appeared to be significantly impaired.

2. Although the Retirement System acknowledged that significant losses had occurred in the direct placement portfolio, it continued to pay its investment managers as though those losses had not occurred.

3. The direct placement investment managers also were able to increase their fees by doing the following:

   - allowing companies to pay interest due in stock—most of which was worthless—rather than in cash

   - adding investment expenses and interest that was due but not paid onto the original value of their investments

4. Late in fiscal year 1991, the Retirement System replaced its direct placement investment managers and started paying them a flat monthly fee, which would eliminate the opportunities for such managers to artificially increase their fees.

### *Compensating the System's Investment Consultant*

1. Concerns had been raised about the way the Retirement System paid its investment consultant. Instead of paying the consultant directly, the System directed six of its investment managers to place a certain percentage of their investment

transactions with a brokerage firm the investment consultant owned. Because it had to pay brokerage fees for these transactions anyway, the System essentially got the investment consultant's services for free. We found that this practice was fairly common and that the fees being charged were competitive, making this method of payment cost-effective. However, some public retirement systems have rejected this practice as improper, risky, or less accountable.

### *Reporting Investment Values*

1. Concerns had been raised that the Retirement System's losses in its direct placement portfolio were buried in the System's annual financial report to all but the very knowledgeable. Although that was true, the System's fiscal year 1990 financial statements did reduce the total value of its investments by the amount that was known to be "significantly impaired" at the time, as required by generally accepted accounting principles. However, the annual report did not show these reduced values consistently for the direct placement portfolio.

### *Monitoring Compensation Payments and Expenses*

1. Retirement System staff did not always verify that the fee billings or expense reimbursement claims investment managers submitted were accurate before they paid them. This increased the risk that the Retirement System would pay fees or reimburse expenses that were not appropriately charged. In fact, we identified one instance in which a direct placement investment manager had overcharged the Retirement System $74,500 over a one-year period, and Retirement System staff had not noticed the error.

2. In fiscal years 1990 and 1991, the Retirement System reimbursed or added back onto the investment value a total of about $1.8 million for direct placement investment expenses. Other states we contacted did not reimburse their direct placement investment managers for such expenses.

### *Calculating Rates of Return*

1. The rates of return the Retirement System reported for its direct placement and real estate investments were overstated. The reason why: the System's investment consultant did not take certain factors into account. For example, the rate of return included interest income that companies owed to the Retirement System but never actually paid, as well as interest income that was paid to the System in the form of worthless or questionable stock. On the other hand, the rate of return did not include estimated losses on investments that the Retirement System had recorded in its records but that the investment managers had not reported as losses.

### *Investing in Direct Placements and Real Estate*

1. Between 1986 and 1990, the amount of Retirement System funds invested in direct placements and real estate increased from less than seven percent to almost 20 percent of total investments. In other words, about one-fifth of Retirement System funds were invested in high-risk investments.

2. The Retirement System had a higher percentage of its funds invested in direct placements and real estate than 10 other states we contacted. Further, Kansas' direct placement investments were different and potentially more risky than the direct placement or venture capital investments other states made. For example, Minnesota only invested in venture capital investments involving at least four other partners. In Kansas, there were no requirements that other investors share the investment risk. Wisconsin only invested directly in large, national companies that have publicly traded securities.

### *Monitoring the Retirement System*

1. The Retirement System had fewer requirements for its Board of Trustees than any other state we contacted. In Kansas, the governor appoints all seven members of the Board. Most other states' boards had a combination of appointed and elected members. Some also included legislative appointees. Some states also had established standing legislative committees especially for monitoring their public employee retirement systems.

2. Some other states exercised more control over their direct placement and real estate investments than Kansas. In Kansas, the Retirement System's Board of Trustees established broad investment policies, but generally gave investment managers complete authority to make individual investment decisions. Other states sometimes used in-house staff to make their direct placement or venture capital investments, or required their boards of trustees or retirement system staff to approve outside investment managers' investment transactions.

### *Recommendations*

To address these problems, we recommended that the Retirement System do the following:

- improve its procedures for verifying the fee billings and expense claims investment managers submit
- establish a system for independently monitoring the valuation of direct placement investments
- permanently alter its fee structure for compensating direct placement investment managers
- stop allowing investment managers' compensation to be increased by the

amount of income that is not actually paid or that is paid in stock, or by expenses that are added to the value of the investment.
- reconsider whether to compensate investment managers for expenses
- fix the way it calculates rates of return for direct placement and real estate investments, and report corrected rates of return to the Legislature as soon as they are available

To address these problems, we also recommended that the Legislature do the following:

- decide whether to continue making direct placement and real estate investments and, if so, consider specifying the type and amount of such investments that should be allowed
- consider establishing a standing legislative committee to oversee the System's investment policies and practice
- consider amending State law to include legislative appointees and Retirement System members on the System's Board of Trustees.

## Examining Investments in: Tallgrass Technologies, Inc.: Part I<br>Tallgrass Technologies, Inc.: Part II<br>The Hydrogen Energy Corporation<br>The Kansas City Merchandise Mart

These four audits examined three specific investments made by Reimer and Koger Associates, one of the Retirement System's direct placement investment managers. Reimer and Koger loaned a total of $14 million in Retirement System moneys to Tallgrass, $6 million to Hydrogen Energy, and $30 million for the Merchandise Mart. Both Tallgrass Technologies and Hydrogen Energy have defaulted on their loans, and those investments are considered to be 100 percent impaired. The developers of the Merchandise Mart have not defaulted on their loan. Recent estimates of the value of this investment suggest that, if it had to be liquidated, it may have lost one-fourth to one-third of its value.

For each investment, we determined whether the investment complied with the System's investment policies, what financial condition the company was in before and during the time Retirement System moneys were invested in it, how much the investment had earned for the System, and how much the investment manager was paid to manage that investment. In addition, for the investment in Tallgrass Technologies we determined what oversight the Retirement System's staff and Board of Trustees exercised, and for the investment in the Merchandise Mart we identified factors that have affected the value of the System's investment.

In general, we found the following:

### *Complying with Investment Policies*

1. The three investments generally were made according to the specific dollar limits set for such investments, but the investment in the Merchandise Mart complied only because the Board of Trustees changed the maximum amount allowed in any one investment. In addition, this policy change was made by a telephone vote that apparently was not a legally binding action.

2. We found certain aspects of each investment to be imprudent, despite the Board's general investment policy that all investments meet the "prudent-man rule." For example:

   - Reimer and Koger bought out Tallgrass Technologies stockholders for $1.6 million when the company was in a serious financial decline. This transaction provided no additional money for the company, and the Retirement System acquired worthless stock. The investment manager also converted $8 million in debt to common stock, putting the Retirement System behind every other creditor if the company is liquidated.

   - Reimer and Koger's investment in Hydrogen Energy was even more speculative than its investment in Tallgrass. It loaned Hydrogen Energy $3.4 million in 1987, 1988, and 1989, even though the company could not pay interest on previous loans and had an operating income of less than $50,000 in all three years combined.

   - Reimer and Koger made a $30 million loan for the Merchandise Mart based on the Mart's value if it were fully leased, knowing the developers had lease commitments only for about half the facility. (After six years, the rest of the facility still has not been leased, and the facility's appraised value has dropped by more than one-third.) In addition, the loan was made without requiring the developers to commit significant funds, and without recourse against the developers' assets if the loan was not repaid. Finally, the loan was made even though the manager knew that some key provisions probably were not enforceable if the developers' ever defaulted. In other words, the Retirement System bore all the risk for this investment.

### *Investing in the Companies*

1. Tallgrass and Hydrogen Energy had financial difficulties even before Reimer and Koger invested in them. Hydrogen Energy's difficulties were severe; its total liabilities exceeded its total assets when Reimer and Koger loaned it $2.5 million, and its debts due within one year were more than twice as large as its liquid assets. Tallgrass' financial problems surfaced just before the Retirement System's investment in the company. We did not find that Reimer and Koger has prepared a standard "due diligence" report for this investment.

2 The Tallgrass and Hydrogen Energy investments exhibited several disturbing patterns. For example, in both investments we found that Reimer and Koger had done the following:

- made $11.2 million in additional loans to both companies even after it had independent information showing that Tallgrass and Hydrogen Energy's financial conditions had seriously declined, and casting doubt on whether they could continue to operate.

- made additional loans to the companies to pay off old loans or the interest due on them. Reimer and Koger also capitalized more than $1 million in unpaid interest (which means it added that amount to the loan principal). The result: the Retirement System's investments seemed to be performing well on paper, even when they were not.

- converted loans to stock that was essentially worthless. This practice made the companies' balance sheets look good, but the Retirement System gave up its position as a creditor and acquired worthless stock in the process.

In addition, several of these practices actually increased Reimer and Koger's base management fees for these investments.

### *Factors Affecting the Value of the Merchandise Mart*

1. Concerns that the value of the original appraisal for the Merchandise Mart was inflated through land sales or the switching of leases did not appear to be well-founded. The Merchandise Mart's value has decreased by 35 percent or more since the Retirement System's 1986 investment in the Mart, but the primary reason was the lack of a tenant for the lower level of the facility. A key factor in the original appraisal was the rental income a lower-level tenant would pay. Because the lower level has not been leased, subsequent appraisals had to take the lack of income into account.

### *Earning Returns on the Investments*

1. None of these investments has performed well. Considering just the interest or dividends actually paid:

- the $14 million investment in Tallgrass Technologies earned a high of 6.9 percent in 1987, but has earned 0 percent since 1989.

- the $6 million investment in Hydrogen Energy had produced an average annual rate of return of 2.3 percent through 1990.

- the $30 million investment in the Merchandise Mart has earned the highest rate of return, averaging 10 percent a year since 1986. Through July 1991, more than $15 million in interest had been paid.

2. On all three investments, at least some interest that is owed has not yet been paid. This accrued interest amounts to the following:

   - Tallgrass Technologies owes the Retirement System $2.2 million in accrued interest.

   - Hydrogen Energy owes the Retirement System $1.7 million in accrued interest.

   - The Merchandise Mart's developers owe the Retirement System an estimated $1.9 million in accrued interest. If the Mart continues to operate at a loss throughout the life of the loan, the developer would owe the Retirement System a total of $69 million in deferred cash payments alone at the end of the 25-year loan.

3. All indications are that the full $14 million investment in Tallgrass Technologies and $6 million investment in Hydrogen Energy are virtually worthless. The Merchandise Mart now is valued at $21-24 million.

4. The Merchandise Mart is not generating enough money to pay the minimum interest owed on the Retirement System's mortgage. The developer has contributed about $80,000 a month—or nearly $1 million a year—to keep the loan current. A number of factors have increased the developer's expenses for the Mart over the years without a corresponding increase in revenues. While this may not affect the value of the Retirement System's investment in Mart immediately, it eventually could increase the likelihood of a default on the Retirement System's loan.

### *Compensating the Investment Manager*

1. Reimer and Koger was not paid fees for investments in individual companies; rather, it was paid a fee for its entire direct placement investment portfolio. We estimated the firm was paid about $292,000 for the Tallgrass investment, $123,600 for the Hydrogen Energy investment, and $1.3 million for the Merchandise Mart investment.

### *Oversight of the Tallgrass Technologies Investment*

1. The Retirement System's oversight procedures were totally inadequate to minimize the likelihood and severity of investment losses.

2. The Board and staff exercised no oversight of the initial decision to invest in Tallgrass, or of how much was ultimately invested. All decisions were left up to the investment managers, who later held positions on the company's board of directors, and who may have come to believe that what was good for the company was good for the Retirement System.

3. The Retirement System's staff did not act even when it had information suggesting there were losses in the direct placement investment portfolio. Since 1987, the System's annual, independent financial-compliance audits had indicated an increasing concern about the reported value of direct placement investments. Staff also did not report such information to the Board of Trustees, which had ultimate responsibility for those investments.

4. Essentially, then, the Retirement System had no way to ensure that the following happened:

   - the amount invested in a company was commensurate with the value of that company

   - the investment manager was always acting in the best interests of the Retirement System, and investments were being made on an arm's-length basis

   - losses in the direct placement portfolio were identified and actions taken to help minimize them

### *Recommendations*

We made a number of recommendations to address the problems listed above. Among other things, we recommended that the Retirement System or its Board of Trustees do the following:

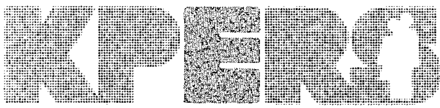
- establish a specific limit on the portion of Retirement System funds that may be invested in direct placements (the Legislature also could establish statutory limits)
- require co-investors for all direct placement investments, or require investment managers to ensure that other parties have committed significant funds to the investments
- explicitly require investment managers to conduct due diligence reviews before they can make any initial direct placement investments
- require investment managers to establish clearly defined performance expectations for each investment at the outset, and periodically compare each investment's actual performance to those goals
- prohibit investment managers from being in control of the companies they invest in
- require investment managers to report to the Retirement System any time a company defaults on a Retirement System investment

- exercise timely and active oversight for any individual investment that is troubled by approving investment transactions and requiring reports from investment managers
- require periodic, independent valuations of significant direct placement investments, and use those valuations to review the investment managers' performance
- ensure that compensation paid to direct placement managers takes into account the results of those periodic, independent valuations
- consider managing direct placements in-house if effective oversight of direct placement managers cannot be provided cost-effectively

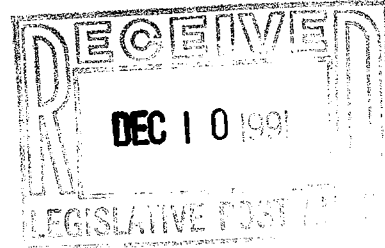
# APPENDIX A

## Agency Response

A copy of the draft report was sent to the Kansas Public Employees Retirement System for its review and comment on December 9, 1991. The agency's response to the report is presented in this Appendix.



Kansas Public Employees Retirement System




December 10, 1991

Barbara J. Hinton
Legislative Post Auditor
Legislative Division of Post Audit
1200 Merchants Bank Tower
8th & Jackson
Topeka, KS 66612-2212

Dear Ms. Hinton:

We appreciate the opportunity to respond to the draft copy of the completed summary report for the six recent performance audits of the Retirement System, Summary Report of Direct Placement Investments and Investment Practices of the Kansas Public Employees Retirement System.

We are pleased to see that the report does indicate that substantial changes have occurred in the Retirement System's investment procedures and practices. In fact, we would point out that the Retirement System has positively responded to each audit recommendation, not just with plans but with positive actions already underway.

The question concerning the public dissemination of proprietary information is appropriately part of the public debate, on the extent to which and the manner in which the Retirement System should participate in the private placement marketplace.

The Retirement System appreciates the contributions of the six audits. The recommendations have been addressed. The Retirement System, at the direction of the Board of Trustees, has reoriented its efforts to emphasize oversight and accountability. The Board of Trustees and the staff of the Retirement System continue to be committed to aggressive, proactive, and ongoing oversight of not only the direct placements, but all of the Retirement System's investments.

We trust that this summary narrative document will prove to be helpful in facilitating meaningful discussion and deliberation concerning the future investment parameters, policies, and practices of the Retirement System. To that end, we look forward to addressing any questions that the Legislators might have.

Sincerely,

Meredith Williams
Executive Secretary



Capitol Tower ■ 2nd Floor ■ 400 W. 8th ■ Topeka, Kansas 66603-3911 ■ Phone (913) 232-6665
KPERS Telephone Facsimile (913) 232-3041
In Kansas, Call Toll Free 1-800-228-0366