NEW YORK STATE
DEPARTMENT OF FINANCIAL SERVICES

State Comptroller-Managed Common Retirement Fund Pays High Fees Year After Year for Poor Hedge Fund Performance and Lacks Transparency on Costs of Other Alternative Investments

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INTRODUCTION

The Superintendent of the Department of Financial Services (ñDFSò) supervises New York Stateôs actuarially funded public retirement systems. N.Y. Retire. & Soc. Sec. Law §§ 15, 315. As the regulator of these public retirement systems, the Superintendent has the authority to review the work of the systemsô trustees and managers, makes inquiries concerning the systemsô condition, and can promulgate regulations concerning their operations.[1]

As part of its oversight authority, DFS has reviewed the investment activities of the Common Retirement Fund (ñCRFò), the investment arm of two state pension systems, the New York State and Local Employeesô Retirement System (ñNYSERSò) and the New York State and Local Police and Fire Retirement System (ñNYSPFRSò and collectively with NYSERS, the ñState pension systemò or ñSystemò). The New York State Comptroller (ñComptrollerò) runs both benefit and investment operations for these systems. Unlike other pension systems, the Comptroller is the sole trustee of the System with complete authority and responsibility for its operations and investments. While there are various part-time volunteers serving on advisory boards, there is no legally mandated Board of Trustees to provide direction to the Comptroller, the New York State Office of the State Comptroller (ñOSCò), or the State pension system itself.

This report assesses the investment activities set forth in the Comprehensive Annual Financial Reports of the State pension system for fiscal years ending March 31, 2009 through March 31, 2016.[2] In particular, for this report, DFS has reviewed the place of hedge funds and private equity in the stateôs pension portfolio.

In summary, as discussed in more detail below, as state pension fund managers around the country have cut or eliminated exposure to overpriced and underperforming alternative investments, under the Comptrollerôs watch the State pension system has spent large amounts of pension system funds chasing returns and performance that has fallen far short for years. Specifically, over the past eight years, the System has paid over $1 billion in excess fees to hedge fund managers who underperformed to the tune of $2.8 billion. Just last week, in fact, the Comptrollerôs Office admitted that hedge fund compensation has been excessive and unfair to

[1] The Superintendent also has the power to conduct examinations of public retirement systems. N.Y. Ins. Law § 310-12 and § 314; N.Y. Insurance Regulation No. 85, 11 N.Y.C.R.R. § 136. DFS will soon commence an examination of NYSERS and NYSPFRS for the five-year period from April 1, 2011 through March 31, 2016, and will also commence examinations of other pension systems over which it has authority.

[2] http://www.osc.state.ny.us/retire/about_us/financial_statements_index.php

pension fund beneficiaries. And while it now appears that the Comptrollerôs Office may be seeking to limit hedge fund fees, this is too little too late. In addition, the Comptrollerôs pension investments in private equity should provide more transparency in the entire sector on fees and expenses. As to both areas, for years the State Comptroller has been frozen in place, letting outside managers rake in millions of dollars in fees regardless of hedge fund performance, and tolerating large private equity fees and expenses without obtaining necessary transparency.

I.

HEDGE FUNDS – OSC IS STICKING WITH A BAD IDEA

Outside experts have long warned that so-called ñactiveò management ï with its higher fees ï is likely to underperform low-cost diversified index investing. It is well established that while there are no guarantees on expected returns, minimizing costs is a key factor in achieving returns. Hedge funds thus start with two strikes against them: a significant risk of long-run underperformance for delivering excess returns, and the highest fees and expenses among the many actively-managed investment options. The end result is that the State pension system paid way too much and has given pensioners nothing except lagging returns. The Comptroller is responsible for protecting the State pension system from overpaying dozens of outside managers charging many millions in excess fees.

A. OSC Is Paying Excessive Hedge Fund Fees

Specifically, in the past fiscal year (ending March 31, 2016), the State pension system paid over $150 million in fees to hedge fund managers (termed ñAbsolute Return Strategyò), for managing $8.0 billion in assets, or approximately 4.5% of the assets of the System.[3] This $150 million in fees represents a 1.87% fee on State pension system assets under management by hedge funds. *In fact, over the past 8 years, $1 billion has been paid by the State pension system to hedge fund managers – and the results plainly do not justify this extravagant amount.*

[3] New York State and Local Retirement System, *2016 Comprehensive Annual Financial Report* (For Fiscal Year Ended March 31, 2016) (“2016 CAFR”) at 91, 101, 116-117. http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_16.pdf

By contrast, the System paid $59.2 million in fees and commissions in the past fiscal year for the substantially greater $61.5 billion invested in domestic equities, representing 34.5% of the assets of the System. This $59.2 million represented 0.096%, a less than 1/10th of 1% fee on assets under management.[4] In other words, the fees paid to hedge fund managers were wholly lopsided when considering fees paid for other assets under management.

Indeed, had the hedge fund managersô services cost the CRF the same as that paid for domestic equities, the bill would have been just $7.7 million ï a savings to taxpayers of $142 million for one year. And, if the domestic equity portfolio had the same costs as the hedge funds, the bill would have been a whopping $1.15 billion in 2016 alone. The numbers indicate that in this case a dramatically better return was obtained at a 95% discount. Domestic equities have 7.7 times greater assets, but hedge funds cost 2.5 times more. *When one combines both factors, the result is that the State pension system has been paying 19½ times more for hedge fund management than domestic equities.* In short, the Comptrollerôs Office authorized extraordinary fees paid to hedge fund managers when those investments significantly underperformed investments costing substantially less.

B. Hedge Fund Profit Sharing Creates a Risk of Excessive Risk Taking

The standard hedge fund compensation model includes profit sharing with managers that may harm the State pension system. Profit sharing ï that is, agreeing to pay a larger fee for a high return ï may incentivize some hedge fund managers to take excessive risks in order to reap high rewards, with the pension system shouldering the additional risk. The standard profit sharing levels ï typically 20% for individual investors, and frequently at least 10% or 15% for institutional investors ï make profits extraordinarily valuable to the hedge fund manager while encouraging excessive risk taking by some. Taking extraordinary risk will be rewarded excessively if it leads to profits, but extraordinary losses are punished only by eventual termination, and the hedge fund manager does not share in the losses borne by the pension fund and is still assured of an above-market fee scale based on assets until terminated (typically 2% - compared to less than 1% for ordinary active funds, and substantially less for passive exposure to a broad market index such as the Russell 3000).

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[4] 2016 CAFR at 91, 102-104.

Considering the range of results across the hedge fund asset class, profit sharing compensation creates a risk where the system-selected managers with the worst performance may have the greatest incentive to gamble. Once a fundøs performance lags market returns, the incentive to gamble is even greater as certain managers are doubly incentivized to not only hit profit sharing goals but also to avoid an otherwise likely termination from simply following sound ï albeit in particular instances unsuccessful ï principles of investment risk management. Looking across an entire group of mangers, it is easy to see that the likely losses from the bad managers taking high risks will exceed any above-market returns from successful but appropriately risk-controlling managers.

If profit sharing is a one-way incentive to increase risk, and to double down after every loss, the hedge fund asset class will be a risky underperformer. There is a hidden risk of outsize losses spiraling out of control unless the Systemøs manager, here the OSC, deploys adequate resources to the monitoring of hedge fund managers. Moreover, simply threatening termination for underperformance amplifies rather than reduces the hazard of doubling down on risk. Underperforming managers cannot be given the opportunity to gamble with employee retirement funds and then call on taxpayers to make up the losses.

At the very least, this search for outsized returns requires the OSC to monitor outside managers with intensive focus on immediate risk detection and control. Plunging into alternative investments without first ensuring adequate staff was in place set up the System for a future crisis, which has already materialized over the past eight years to the tune of billions of dollars.

The eight straight years of underperformance have cost the System an extra $1 billion in excess fees, while delivering a performance shortfall of $2.8 billion compared simply to the 5.4% return on the Systemøs other equity investments.

C. Hedge Fund Underperformed Other Equity Investments By $2.8 Billion

Over the last decade, the returns of hedge funds have been uniformly subpar at the State pension system. The annualized rate of return at the State pension system for the Absolute Return Strategy (hedge funds) in the 5 and 10 years ending March 31, 2016 has been 3.69% and 3.23% per year, respectively. These returns lag the Systemøs overall 5 and 10 year returns of

7.25% and 5.69%. Hedge funds are the worst of the six asset allocation areas with a 10-year record, and stay ahead of last place over 5 years by less than ½ of 1%.[5]

In comparing the 10-year 5.38% return for the Global Equity[6] category with the hedge fund 3.23% return, the bulk of the hedge fund underperformance is due to the higher fees. *The State pension system simply gave away tens or even hundreds of millions of dollars in fees every year for 10 years to hedge fund managers, and received no value in return.*

Over the most recent 5 years, the story is even worse as the gap in performance is well in excess of the fees paid. Global Equity returned 8.03% while the Absolute Return Strategy returned only 3.69%. The State pension system paid a premium price for significantly subpar performance. The OSC has failed to reduce this exposure, and instead has continued to employ outside managers at high fees to invest in underperforming hedge funds. As a result, outside managers chosen by the OSC continue to reap massive rewards for strategies that have not earned appropriate returns for the State pension system.

When first created in the mid-20th century, hedge funds were vehicles that used carefully developed techniques to spot market imperfections and mis-valuations, allowing small and nimble funds to arbitrage opportunities. As these analytical tools and techniques proved successful, and became widely known and copied, the market-beating returns were whittled away by the increased amount of money chasing the same opportunities.[7] That initial track record, based on a very small amount of money operating under the radar and without industry-wide competition, may have been exemplary. But as a mass-market vehicle, hedge fund strategies became a ñcrowded trade.ò The Comptroller came too late for the market-beating outperformance but just in time to select overpriced and underperforming vehicles for the State pension system. Having made this asset allocation, there was ample evidence during and after the recent financial crisis that the experiment was hurting the System, but the Comptroller simply continued the bad bet for years. As a result, the State pension system managed by the

[5] 2016 CAFR p.90 (not including short term investment category, which is primarily a cash management mechanism and yielded 0.46% and 1.54% annualized, over 5 and 10 years).

[6] The "Global Equities" category combines both the domestic and international equity holdings.

[7] Simon Lack, *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good To Be True*, CFA Institute http://www.cfapubs.org/doi/pdf/10.2469/cp.v29.n4.4 (Dec. 2012) ("the hedge fund industry provided higher returns when it was smaller…. 2012 is the 10th consecutive year that an investor in a 60[% stock]/40[% bond] portfolio will outperform hedge funds and save the 2 and 20 management fee…. What happened? In my opinion, it is completely a function of size, although it will never be known unequivocally.")

Comptroller has continued to pay high fees while experiencing an eight-year losing streak of lagging returns.[8]

Having seen three straight years of massive underperformance in 2009, 2010 and 2011, when the Systemôs Absolute Return Strategy underperformed the Global Equity investments by at least 10 percentage points each year, the State Comptroller failed to reassess an obviously failing hedge fund strategy. In fiscal 2011, the Global Equity return of 16.24% was more than 2½ times that of the 5.99% return from hedge funds. Nevertheless, in the course of the next five years, the Comptrollerôs blind devotion to the strategy continued, and Absolute Return assets increased every year while returns lagged: starting at $4.5 billion in March 2011 and ending at $8 billion in March 2016. In yet another 10 percentage point underperformance year ï 2014 ï Global Equity returned double what hedge funds returned. This over $620 million in hedge fund underperformance turns into an $860 million loss to the System in fiscal 2014 alone when excess fees are also taken into account. In fact, in every one of those years Absolute Return performance continued to lag even as System assets were poured in ï and has now reached an eight-year streak of underperformance. At the same time, the OSC has committed the System to paying substantially higher fees.

As the chart below shows, the combination of high fees and underperformance have cost the State pension system at least $3.8 billion over the prior eight years, in fees and foregone profits.

[8] Simon Lack, *The Hedge Fund Mirage* ("In the early years, some sort of equality or fair split of the returns between investment managers and their clients existed, but by 2004, managers began to take a much larger piece of the return pie…. Hedge funds have taken 84% of net real investor profits since 1998. Funds of funds have taken 14%, and only 2% has gone to investors.")

Persistent Hedge Fund Underperformance Cost the System $1 billion in Excess Fees and $2.8 billion in Missed Gains									
	2009[9]	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2009-2016 Total $ Cost**
Absolute Return % return	-18.89%	14.95%	5.99%	-2.36%	7.95%	9.85%	5.87%	-4.78%	
Global Equities % return	-7.12%	26.59%	16.24%	3.17%	13.12%	20.02%	8.16%	-2.86%	
Absolute Return under-performance (versus Global Equities)	-11.77%	-11.64%	-10.25%	-5.53%	-5.17%	-10.17%	-2.29%	-1.92%	
Cost of Absolute Return Under-performance (versus Global Equities)	$626,909,938	$277,120,340	$391,297,645	$248,659,270	$267,067,310	$622,881,380	$169,599,988	$161,065,075	**$2,764,600,946**
Cost of Absolute Return Excess Fees (Versus Domestic Equity asset class fees)	$42,154,274	$44,862,653	$119,533,861	$107,234,559	$159,235,386	$240,090,203	$219,581,310	$142,461,961	**$1,075,154,208**
Total Cost of Absolute Return Strategy (excess fees plus under-performance)	$669,064,211	$321,982,993	$510,831,506	$355,893,829	$426,302,697	$862,971,583	$389,181,297	$303,527,037	**$3,839,755,153**

[9] Fiscal year annualized returns. Data used for calculations derived from 2009 through 2016 CAFRs.

D. State Comptroller Fails To Reconsider His Bad Bet As Other Pension Systems Take Action and Leading Experts Warn Against Hedge Funds

Long before today, many public pension managers have appropriately re-evaluated investment strategies in light of actual results. Reducing exposure to high cost investment managers, and reducing the fees and costs charged for alternative investment strategies, are savings that any prudent fiduciary would be expected to pursue.

In fact, many public pension systems have taken significant steps to eliminate or reduce their hedge fund exposure, including in California, Illinois, and New Jersey.[10] Other systems have sought to develop paths for investing that significantly reduce their fees.[11] In addition, over 18 months ago, the New York City Comptroller publicly disclosed an internal analysis of the fees and returns on the investments that the five City pension systems had outsourced to Wall Street money managers. The analysis found that ñhigh fees and failures to hit performance objectives have cost the pension system some $2.5 billion in lost value over the past decade.ò[12] Following up on this analysis, the New York City Comptrollerôs Office has indicated that it is in the process of developing a strategy to address overpayment for underperformance. In April 2016, the Board of Trustees of the New York City Employeesô Retirement System voted to exit

[10] *NYCERS Pulls The Plug On Hedge Funds*, http://www.pionline.com/article/20160418/PRINT/304189975/nycers-pulls-the-plug-on-hedge-funds (Apr. 18, 2016)("CalPERS announced in September 2014 that it would eliminate its $4 billion hedge fund program, citing complexity, cost and scale.… As of Dec. 31, 2015, the $290.7 billion California Public Employees' Retirement System, Sacramento, held only $463 million in hedge fund investments."; "The Illinois State Board of Investment announced in February it would lower its hedge fund allocation target to 3% from the current 10%."). *New Jersey Slashes Hedge Fund Portfolio In Asset Class Overhaul,* http://www.pionline.com/article/20160803/ONLINE/160809949/new-jersey-slashes-hedge-fund-portfolio-in-asset-class-overhaul (Aug. 3, 2016) ("Reducing the overall hedge fund target allocation to 6% of total plan assets for the current fiscal year, which started July 1, from 12.5% in the last fiscal year … The division predicted that the revised hedge fund strategy would save $127 million per year…."); *R.I. Pension System To Drop More Than Half Of Its Hedge-Fund Investments* http://www.providencejournal.com/news/20160928/ri-pension-system-to-drop-more-than-half-of-its-hedge-fund-investments ("Rhode Island will jettison more than half of the state pension system's $1.1 billion in hedge fund investments.… In the last three years, Rhode Island has paid more in fees to its hedge funds than they have produced in investment returns, according to the treasury. "There is something that is broken here in the fee structure," [R.I. General Treasurer] Magaziner said.")

[11] *Hedge Funds Make Last Place At $61 Billion Massachusetts Pension,* http://www.bloomberg.com/news/articles/2016-08-09/hedge-funds-make-last-place-at-61-billion-massachusetts-pension (Aug. 9, 2016) ("Massachusetts hasn't reduced its roughly 10 percent allocation to hedge funds… [but invested] through managed accounts rather than co-mingled accounts. The strategy has resulted in fee discounts of 40 to 50 percent…").

[12] http://comptroller.nyc.gov/newsroom/comptroller-stringer-billions-in-pension-fund-fees-paid-to-wall-street-have-failed-to-provide-value-to-taxpayers/ (Apr. 9, 2015). http://comptroller.nyc.gov/wp-content/uploads/documents/BAM_Report_Impact_of_Management_Fees.pdf (Apr. 9, 2015).

its $1.5 billion hedge fund portfolio.[13]

At the same time, notable investing experts have drawn attention to the mistakes pension systems make in chasing expensive and unrealistic returns from investments such as hedge funds. For example:

> Warren Buffett, the billionaire chairman of Berkshire Hathaway Inc., said large investors should be frustrated with fees theyôre paying hedge fund managers who fail to match the returns of index funds. ñThereôs been far, far, far more money made by people in Wall Street through salesmanship abilities than through investment abilities,ò Buffett said Saturday during Berkshireôs annual meeting in Omaha, Nebraska. ñHedge funds traditionally charge a management fee thatôs 2 percent of assets, plus 20 percent on any profits. Thatôs ña compensation scheme that is unbelievable to me,ò Buffett said. He added that some pension funds have disregarded his advice, and gone ahead and hired consultants.
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> Buffett said the cost of consulting and management fees, as well as commissions, eat up investment returns for the wealthy individuals, endowment funds and public pensions that use hedge funds.[14]

Despite all of this, the State pension system, the OSC, and ultimately the Comptroller has continued to invest in grossly underperforming hedge funds, and has continued to overpay hedge fund managers for these lagging returns.

E. Recent Hedge Fund Returns Remain Poor

Recent returns have not improved for the State pension system. Even in down markets, the job of the fund manager is to have comparatively fewer losses. Yet, for the fiscal year ending March 31, 2016, the loss of 4.78% for hedge funds compares poorly with the 2.86% loss for the Systemôs Global Equity portfolio as a whole. Moreover, a simple index fund based on the broad U.S. equity market, such as the Russell 3000, lost only 0.34% during that time, once again

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[13] http://www.bloomberg.com/news/articles/2016-04-14/nyc-pension-votes-to-liquidate-1-5-billion-hedge-fund-portfolio (Apr. 14, 2016).

[14] *BUFFETT SAYS HEDGE FUNDS GET 'UNBELIEVABLE' FEES FOR BAD RESULTS* http://www.bloomberg.com/news/articles/2016-04-30/buffett-says-hedge-funds-get-unbelievable-fees-for-bad-results (Apr. 30, 2016). *See also BUFFETT'S SUGGESTION TO PENSION FUND TRUSTEE: DON'T INVEST IN HEDGE FUNDS* http://www.pionline.com/article/20140609/PRINT/306099987/buffetts-suggestion-to-pension-fund-trustee-dont-invest-in-hedge-funds ("I would not go with hedge funds — would prefer index funds," Mr. Buffett scribbled on the top of the letter Mr. Meiberger had written to him…. Mr. Meiberger reported Mr. Buffett as saying that on a cumulative basis for the six years ended Dec. 31, 2013, the hedge funds had a 12.5% return; the S&P 500, 43.8%.") (June 9, 2014). *BUFFETT SAYS HEDGE FUNDS ARE A BAD DEAL FOR INVESTORS* http://www.cnbc.com/2016/04/30/reuters-america-buffett-says-hedge-funds-are-a-bad-deal-for-investors.html (Apr. 30, 2016).

outperforming the Systemõs hedge funds ï as well as the Systemõs active managers. That 4.44% market outperformance on approximately $8 billion in assets represents a hedge fund underperformance cost alone of $355 million. If the $142 million in excess fees paid to hedge fund managers are added, chasing after the illusory returns of the most expensive form of active management cost the System $497 million in fiscal 2016 alone. It is easy to see how a more thoughtful approach, simply paying attention to the conventional wisdom that it is practically impossible to beat the market over any sustained time period, would have benefited both New York State taxpayers and employees. Even simply putting the System on autopilot by investing in index funds would have saved billions of dollars.

II.
FALLING PREY TO HIGH PRIVATE EQUITY FEES AND HIDDEN EXPENSES

A separate set of concerns arises from the State pension systemõs investments in another alternative asset class, private equity, which despite reporting above-average returns, over the past ten years has had issues relating to costs and expenses that would have been credited against fees otherwise owed, and paid, by the limited partner investors ï including the Common Retirement Fund run by the State Comptroller. Returns on private equity seem to be trending downward.[15]

For example, auditors and investigators are challenged to disentangle hidden monitoring fees for little and sometimes inexpert monitoring, expenses for services to portfolio companies obtained at a discount but billed at full price with the private equity manager or affiliates retaining the undisclosed difference, and unrelated costs slipped in among legitimate expenses. The U.S. Securities and Exchange Commission (ñSECò) has responded by creating an entire unit to scrutinize private equity business practices.

The Comptroller has been aware of these private equity fee arrangements for some time. In July 2015, he joined a dozen colleagues, who serve as State Treasurers or public pension managers, to ask the SEC to require transparent fee and cost disclosure by the private equity

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[15] Nir Kaissar, Private Equity's Diminishing Returns, Bloomberg Gadfly, May 11, 2016 available at https://www.bloomberg.com/gadfly/articles/2016-05-11/private-equity-has-diminishing-returns (last visited October 6, 2016); http://www.bloomberg.com/news/articles/2014-05-06/sec-finds-illegal-or-bad-fees-in-50-of-buyout-firms (May 6, 2014).

general partners who manage investment funds.[16] But asking for assistance from the SEC is not action. Simply waiting for the SEC to fully investigate an industry, and then craft and adopt appropriate rules, is not action by the sole trustee of the State pension system charged with protecting its assets and promoting the interests of beneficiaries. At the very least, if there were a lack of transparency as to whether the general partners, or their affiliates, are overpaying themselves at the Common Retirement Fundôs expense, pursuing a freeze on fees and expenses until full information is provided would be in order. Continuing to pay the bill in full ï and perhaps overpaying ï is not the path to eliminating excessive expenses. Instead, the Comptroller should confirm that full disclosure occurs before any payments go out the door.

The State pension system is now searching for ways to lower fees in this asset class by taking on in-house more of the work of underwriting co-investment opportunities. It has only recently discovered what should have been clear long ago ï that making a commitment to alternative investments places a much greater monitoring burden on the investor. Taking on asset allocations that are complex to monitor and oversee and only belatedly understanding the challenges reflects poor planning.

A. The OSC Must Monitor Private Equity Expenses

The New York State Common Retirement Fund is the fourth largest fund ranked by total assets.[17] As such, it has few peers. Its size, scope, complexity ï and responsibility for more than a million members and beneficiaries ï requires that it use not only those practices or methods that are so regularly observed in retirement plan practice that one would expect to find them used at the CRF but that it also establish best practices in comparison to public retirement plans in the United States and to retirement plans recognized for excellence.[18]

The CRF invests in private equity firms that use its membersô and beneficiariesô money to buy or invest in companies (ñportfolio companiesò). Private equity firms generally earn their profits from those investments when their interests in a portfolio company are either sold or taken public. The private equity firms typically charge their investors, including pension plans, a

[16] Letter re: Standardized Private Equity Fee Disclosure http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf (July 21, 2015).
[17] The Largest Retirement Funds/Sponsors, Pensions & Investments, February 20, 2016.
[18] E.g., CERN Pension Fund, the Canada Pension Plan Investment Board, and the Ontario Teachers' Pension Plan.

management fee of 1% to 2% of assets (including even on as-yet-uninvested amounts which firms will try to put to use in the future) plus a performance fee of about 20% of the profits (which may be calculated after a minimum rate of return is first achieved).

Fees and expenses are the second most influential determinant of investment returns, second only to allocation. In a low interest rate or low return environment, investment performance is even more sensitive to excessive fee and expense amounts. This becomes an even greater concern given that the Comptroller has increased the Systemôs exposure to private equity.[19] Moreover, a far reaching study of private equity funds found that ñabout two-thirds of expected private equity revenue comes from fixed-revenue components that are not sensitive to performance.ò[20] Thus, if two-thirds of the fees that private equity firms and managers earn are due to fixed factors, it becomes even more important for OSC to ensure that the fees that are paid are appropriately earned.

New York Insurance Regulation No. 85 (ñReg. 85ò) states that ñthe Comptroller shall perform his or her responsibilities with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.ò[21]

Specifically with respect to fees and expenses, Reg. 85 states that, ñ[t]he Comptroller shall maintain records that set forth the expenses incurred by the retirement system and the fund on their behalf in the course of operations.ò[22] The Comptroller must classify the accounts ñconsistent with the requirements of the accounting and financial reporting standards of the Governmental Accounting Standards Board and any reporting requirement judged necessary by the superintendent.ò[23] Properly classified and itemized reporting of expenses is essential to

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[19] "The total number of external active mandates has grown from 471 in 2011 to 521 as of March 2016. The overall growth is attributable to private equity mandates that grew from 239 to 297. CRF's goal is to move toward fewer private equity managers and larger commitments – with a $100 million minimum. The Fund is approving some much larger deals than in the past, e.g., $300-600 million for buyout funds. Private equity has restarted the co-investment program and closed on three co-investments, totaling about $300 million, since last September." Funston Advisory Services LLC, Fiduciary and Conflict of Interest Review of the New York State Common Retirement Fund, p. 66 (August 2016).

[20] Andrew Metrick and Ayako Yasuda, The Economics of Private Equity Funds, Review of Financial Studies, Vol. 23, No. 6 (June 2010).

[21] 11 N.Y.C.R.R. § 136-2.3(a).

[22] 11 N.Y.C.R.R. § 136-2.5(e).

[23] 11 N.Y.C.R.R. § 136-2.5(d).

proper investment analysis, portfolio management, and the prevention and detection of potential abuses.

In June 2012, the Governmental Accounting Standards Board attempted to address private equity investment accounting through Government Accounting Standards Statement No. 67. Paragraph 26 provides:

> ñInvestment-related costs should be reported as investment expense if they are separable from (a) investment income and (b) the administrative expense of the pension plan.ò

Statement No. 67 still leaves to a pension planôs discretion how to interpret what costs are separable and, therefore, reportable. Thus, it is still possible that very material costs that are netted from returns are excluded from financial statements. In practice, the amended guidelines have not led to more transparent cost disclosure, especially for private equity.

For just these reasons, as well as additional considerations below, DFS staff suggested in 2013 ï during discussions with the State pension system ï that the System should employ private equity reporting standards based upon those either recognized, or being developed, by the SEC, the International Organization of Securities Commissions, the CFA Global Investment Performance Standards, the Private Equity Guidelines Group, the International Private Equity and Venture Capital Investor Reporting Guidelines, the International Limited Partners Association Private Equity Principles, or the Alternative Investment Management Association.

More than two years later, the OSC ñendorsedò the Institutional Limited Partners Association Fee Reporting Template Version 1.0 (the ñILPA Fee Reporting Templateò or ñTemplateò). But it is not clear that OSC is requiring any new reporting as a result. In July 2015, the Comptroller joined eleven other state public pension plan officials in asking the SEC to engage in a dialogue about standardized private equity fee disclosure reasoning that to ñvoluntarily disclose more comprehensive accounts of total fees and expensesò would put New York at a disadvantage in state-to-state comparisons.[24] In other words, rather than taking action, the Comptroller, as trustee for one of the largest pension plans, apparently is waiting for guidance from others, who do not have any fiduciary duty to the State pension system and its

[24] Letter from New York State Comptroller Thomas P. DiNapoli (for the New York State Common Retirement Fund) *et al.* to Mary Jo White, Chair, U.S. Securities and Exchange Commission "Standardized Private Equity Fee Disclosure" http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf (July 21, 2015).

members and beneficiaries, and are not on any predictable schedule for further discussions, let alone action.

B. When Hidden Private Equity Fees and Expenses Were Detected, Other Pension Systems Sprung to Action

Public pension plans in New Mexico, South Carolina, Kentucky and New Jersey conducted their own internal assessments of their private equity costs and found them to be as much as 100% higher than originally disclosed.[25] In 2013, for example, South Carolina concluded that the state had spent $418.3 million per year on outside money managers, producing a figure that for the first time could be reported in all of the stateõs pension-fund financial disclosures.

In April 2015, more than three months before the New York State Comptrollerõs letter asking the SEC to engage in discussions on unwarranted private equity expenses and inadequate disclosures, New York City Comptroller Scott Stringer announced that his analysis of previous private equity fund expenses found a shortfall in performance. In October 2015, Comptroller Stringer sent a letter to private equity funds demanding details of their billing and said he would remove them from his portfolio if they did not comply.[26]

No similar analysis or demand for transparency has come from the State Comptroller, leaving the State pension system in the dark. While the Funston Advisory Services (ñFASò) ñFiduciary and Conflict of Interest Review of the New York State Common Retirement Fundò commissioned by the Comptroller stated that ñfew public pension funds report private equity carried interest or partnership expenses todayò and that the Comptroller stated to FAS that he ñwantsò to be as transparent as possible regarding fees, it is up to the Comptroller to actually ñdevelop a standard approach and definitions, perhaps in cooperation with other peer public funds, for reporting the expanded fee and expense information for private equity to improve

[25]Timothy W. Martin, Pensions' Private-Equity Mystery: The Full Cost, Wall Street Journal, Nov. 22, 2015 6:38 p.m. ET, Wall Street Journal *available at*: http://www.wsj.com/articles/pensions-private-equity-mystery-the-full-cost-1448235489 (last visited September 30, 2016).

[26] Robert Steyer, NYC Retirement CIO calls for complete fee disclosure as stipulation for future business, Pensions and Investments Online, Oct. 21, 2015, *available at*: http://www.pionline.com/article/20151021/ONLINE/151029967/nyc-retirement-cio-calls-for-complete-fee-disclosure-as-stipulation-for-future-business (last visited Sept. 30, 2016).

transparency and comparability.ö[27] CRFôs position as one of the largest pensions funds, and its fiduciary duties to its members and beneficiaries to exercise due care, require nothing less. The public is entitled to know exactly how much has been paid in private equity fees and what probable future fees will be.

This is not a new topic, and demanded action long before now. When detected, abusive fee allocation and expense practices in the private equity arena have most often included the following:

- Double dipping;
- Failure to share monitoring fee income;[28] and
- Using consultants to avoid sharing fees.

Accordingly, the SEC has highlighted vigilance to fees as imperative for private equity firms and has brought actions against private equity funds for:

- Advisers that receive undisclosed fees and expenses;
- Advisers that impermissibly shift and misallocate expenses; and
- Advisers that fail to adequately disclose conflicts of interests, including conflicts arising from fee and expense issues.[29]

It is imperative that all pension system managers heed this advice.

C. Private Equity Fees & Expenses – Specific Shortcomings and Needed Improvements

Before investing in private equity, the Comptroller should have ensured that any fees and expenses were known and transparent, and will be justified by the returns. Private equity investments are known to encompass several types of fees and expenses that reduce the return investors receive from private equity investments.

For starters, private equity funds make direct payments to fund managers, affiliates and third parties, including commitment fees, call fees, and fees based on the total cost of the assets

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[27] Id. at 7.

[28] The Comptroller has noted this. Letter from New York State Comptroller Thomas P. DiNapoli (for the New York State Common Retirement Fund) *et al.* to Mary Jo White, Chair, U.S. Securities and Exchange Commission "Standardized Private Equity Fee Disclosure" (July 21, 2015) (acknowledging that management fees reported by state pension funds often do not reflect total private equity management fees).

[29] Andrew Ceresney, Director, United States Securities and Exchange Commission Division of Enforcement, 2016 Keynote Address at the Securities Enforcement Forum West: Private Equity Enforcement (May 12, 2016).

acquired. These costs also may include expenses for legal costs, audit costs and taxes, and fees for advisory services, monitoring, and funding. Although some private equity funds provide reimbursements or rebates, these amounts are still expenses to limited partners ï such as the Common Retirement Fund.

Within this first set of direct management fees are incentive fees such as profit sharing, preferred returns and carried interest. Carried interest is a performance incentive for managers ï a share of the profits paid to the investment manager over the amount that the general partner or manager contributes to the partnership. Because carried interest is usually determined at the end of an investment, it may be difficult to predict or record until the portfolio company is sold; nevertheless, some allowance should be made for the expense in reporting because it can reduce projected returns by a significant amount.

In addition, some private equity funds have charged ancillary fees to portfolio companies for services that the funds provide to those portfolio companies. While these fees are charged to the portfolio companies, that charge reduces the portfolio value available to the limited partners such as the Common Retirement Fund. These fees can include fees for arranging financing for the portfolio companies, for monitoring portfolio companies for the private equity fund, and for arranging acquisitions and divestitures of assets. Because private equity funds might be charging fees like these to its own investors (as general management fees), the investors must be diligent and assure that these fees are offset by reductions in the management fees they pay to the private equity fund.

Furthermore, leakages that reduce investment returns to the System may include expenses such as the investorsô internal costs of monitoring investments and related-parties fees and expenses.[30] Related parties are entities related to or affiliated with, but legally distinct from, the general partner. They might provide services (e.g., legal, brokerage, financing, management, or accounting) to the portfolio companies controlled by the general partner. A potential conflict of interest might arise because the general partner might be able to authorize the portfolio companies to pay above-market prices for related partiesô services.

[30] These also include placement fees but, as DFS Insurance Reg. No. 85 prohibits the Fund from engaging, hiring, investing with or committing to an outside investment manager or a placement agent to obtain Fund investments, 11 N.Y.C.R.R. § 136.2-4(d) (2016), we do not consider those costs here.

The OSC now reports private equity fees on both expensed and capitalized bases. While this dual reporting alone suggests the complexity of private equity funds and their fee structures, it is not possible to fully understand the fees or expenses that may be incurred. To ñget a handle onò these fees and expenses, the Comptroller should develop systems to reconcile these items and make the results public so that members and beneficiaries can understand the costs that are being imposed on their retirement savings.

While OSC now breaks out consulting and monitoring fees, all of these expenses should be itemized clearly so that members and beneficiaries can fully understand whether these fees are paid to outside consultants or are costs internal to the system. At a minimum, these categories should include carried interest and partnership expenses.

D. Simply Endorsing Better Reporting Is Not Enough

As noted, the OSC has ñendorsedò the ILPA Fee Reporting Template, but apparently has not required private equity firms with which it does business to actually use the template for all future reporting, nor has it required disclosures of any prior failings in earlier reporting of fees and expenses.

In any event, the Template alone is insufficient. According to the Suggested Guidance to the ILPA Fee Reporting Template (the ñGuidanceò), the Template itself is only one component of three of the ILPA's Fee Transparency Initiative.

The Template details funds paid to the fund manager, affiliates and third parties. That is, it deals only with the direct costs of dealing in a private equity fund and summarizes the general partnerôs sources of economics regarding the private equity fund and the investments made by that fund (including reimbursements, rebates and any fees not subject to offset). Its disclosures are useful only if they accurately reflect the terms of the private equity fundôs limited partnership agreements and its valuation policy. To the extent that the agreements or valuation policies differ, it will be difficult for CRF to properly compare fees and expenses across its investments.

The Template is intended to be applied on a going forward basis. Because of operational constraints, and what it terms the ñincremental value of the information,ò the ILPA advises against requiring general partners to retroactively report the full breadth of the information within the Template for older funds. So, to the extent that comparable detail does not already exist for past investments, the adoption of the Template would not make fee comparisons across past investments or to future investments possible.

The Template has a two level reporting structure. The first is only a very high level, abstract summary. The Systems and the CRF should insist on Level 2 reporting to assure proper granularity and itemization (e.g., fees subject to offset and partnership expenses, and fees/reimbursements received from portfolio investments).

The ILPA has revised its existing best practices documents (call/distribution notices and quarterly reporting standards) to reflect key components of the Template and the Comptroller should adopt those as well.

The Comptroller's endorsement alone is not enough to bring hidden fees and expenses into the light.

III.
CONCLUSIONS AND RECOMMENDATIONS

The combination of high hedge fund fees and hedge fund underperformance has cost the State pension system $3.8 billion over the past eight years. The Comptroller's Office now, finally, appears to be reviewing the fee structure but still has no answers for the continued use of such expensive and underperforming funds. Nor has any explanation been given for the inaction for eight years while the funds suffered. Given the State pension system's experience with hedge funds in fiscal years 2009, 2010, 2011 and 2014 when returns lagged the general Global Equities category by a whopping 10 percentage points in each year, the failure to reassess the use of such high cost funds after those repeated and persistent deficits is more than troubling.

A common response to criticism about investment performance is that the market is unpredictable and hindsight is 20/20. But the job of the Comptroller acting as the sole trustee in control of the System is to manage market risk and protect the pension fund assets. Here, with respect to the negative impact of high fees on investment returns, *foresight* should have been 20/20. A contract to overpay hedge fund managers, when the probability of underperformance is high, makes no sense. When the actual experience of underperformance, year after year, is added to the analysis, action was necessary long before now.

The Comptroller claims that he needs more staff and more in-house capabilities to do his job, implicitly admitting that OSC has not been adequately managing these investments, nor has it made effective use of lower fee pathways for exposure to alternative investments. But the issue is less the size of staff than its allocation. Recently, the Comptroller publicly stated that he has the staff necessary to take on a new task that he currently does not have, involving state contracting. The Comptrollerôs core mission includes managing the State pension system, which requires deploying existing staff to fulfill the obligations of the office as required by law. Particularly given the poor returns of existing hedge fund investments and the excessive and opaque fees and expenses, the Comptroller should focus on protecting the State pension assets and deploy existing staff to meet these obligations.

Regarding the use of hedge funds, DFS is considering potential regulations on fees and profit sharing, as well as pre-approval of contracts that provide for fees or profit sharing in excess of a certain rate.

As to transparency of private equity fees and expenses, the Comptroller should at a minimum:

1) Develop a comprehensive accounting for all fees and expenses related to CRFôs private equity activity;

2) Develop an internally consistent method to record and report all expenses incurred across all private equity investments so that fees and expenses can be compared and opportunities for reducing costs can be identified;

3) Impose and/or reinforce processes to review existing private equity arrangements to assure that existing fee and expense allocation comply with their agreements;

4) Make public all information regarding fees, expenses, and carried interest; and

5) Require general partners to restate prior reports to provide transparency consistent with any new requirements, and to affirmatively self-report any prior questionable practices for further review.

DFS will monitor these matters in upcoming examinations and reviews.