

## Memo

To: Kevin SigRist, Chief Investment Officer  
Blake Thomas, Assistant General Counsel  
**North Carolina Department of State Treasurer**

---

From: HEK Fiduciary Services

---

Date: May 22, 2013

---

Re: IMD Decision-Making Compliance and Fee Report Findings and Recommendations Summary

---

The following is a summary of HEK's key findings and recommendations regarding the reasonableness of fees for investments made during the Review Period fees and the IMD's compliance with its decision-making processes. To facilitate your consideration, we have included a recommendation summary matrix in the Report (See Tab 5). The Report notes that the IMD has already started to implement several of the recommendations. Examples include: creation of a charter for the internal investment committee, and enhanced documentation describing the investment selection decision-making process for each asset class. We hope you will find that the Report's findings and recommendations add value to the prudent management of the NCRS. We thank each of the NCDST staff members that worked on this project for their diligent efforts.

### **Fees:**

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

### **Key Findings:**

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

**Recommendations:**

We have no recommendations related to fees.

**Compliance with Decision-Making Process**

Overall we found the IMD's compliance with its decision-making processes to be sound.

**Key Findings:**

1. The investment decision-making process is founded upon a comprehensive investment policy statement (IPS), adopted by the Treasurer, which is consistent with best practices.
2. The soundness of IMD's decision-making process has been advanced by the recent establishment of an internal investment committee, which we believe is an excellent approach used by cutting-edge institutional investors to promote oversight and compliance.
3. The IMD is fundamentally in compliance with the IPS requirement to document the basis for each manager selection decision.
  - Investment recommendation memos exist for virtually all of the private equity, real estate, credit strategy, and inflation protection investments made during the Review Period; exhaustive legal checklists as well as summary memorandums have also been prepared for most of the investment transactions.
4. Prior to entering into an investment agreement, execution of a placement agent disclosure letter is required, whether or not a placement agent was used. Disclosure letters are on file for virtually all of the investments made during the Review Period. Most of these investments did not involve the use of a placement agent. In most cases where a placement agent was used the management fees were reduced by the placement agent's fees. The fees charged were within the typical range for the applicable asset class.

**Recommendations:**

Over the last several years the Treasurer and IMD staff have worked diligently to institute best practices and distinguish the DST as a leading institutional investor. The Report identifies several areas that we believe will assist in this effort, foster continued positive change, add value to the decision-making process, and facilitate compliance. Our recommendations can be categorized into two primary areas: (1) promoting the Treasurer's ability to fulfill her fiduciary duties and achieve positive long-term returns and (2) systemization and strengthening of documentation related to the investment selection process.

Key Report recommendations regarding the IMD's decision-making processes are summarized below:

- Seek a statutory amendment to restore the Treasurer's independent procurement authority.
- Establish a compliance certification cover sheet to accompany each investment transaction presented to the Treasurer which certifies that all statutory and policy requirements have been met.
- Develop a systematic process to regularly monitor and report to the Treasurer on policy compliance.
- Create and adopt a charter for the internal investment committee.
- Enhance and consolidate the documentation describing the investment selection decision-making process for each asset class.

- Require the use of investment recommendation memos for all asset classes, including the establishment of a standardized template
- Consider using asset class consultants to better complement and supplement investment resources
- Implement a centralized log and document management system



**Hewitt** ennisknupp

*An Aon Company*

**NORTH CAROLINA DEPARTMENT OF STATE TREASURER**

**DECISION-MAKING COMPLIANCE AND FEE REVIEW**

**MAY 2013**

(This page left blank intentionally)

## Table of Contents

▪ Introduction	1
▪ Executive Summary	3
▪ Methodology	7
▪ Decision-making Process and Compliance	
▪ “Gap” Analysis	9
▪ Compliance Review	31
▪ Review of Placement Agent Usage and Investment Manager Fees	
▪ Placement Agent Review	39
▪ Fee Review	51
▪ Appendix	
▪ Tab 1 – The Review Universe	53
▪ Tab 2 – Interviewees	57
▪ Tab 3 – Documents Requested and Reviewed	59
▪ Tab 4 – Sample Cover Compliance Sheet	61
▪ Tab 5 – Summary of Recommendations	63

---

(This page left blank intentionally)

## INTRODUCTION

The North Carolina Department of State Treasurer (NCDST) retained Hewitt EnnisKnupp (HEK) to conduct (1) a “gap analysis” and compliance review of its investment decision-making process, (2) a review of placement agent usage, and (3) a review of investment manager fees.

HEK is a consulting firm headquartered in Lincolnshire, Illinois, with a wide array of clients including governmental bodies, non-profits, state and federal oversight entities, public retirement systems, state investment boards, corporate pension funds, endowments, and foundations. HEK is the largest firm of its type in the United States with clients having combined assets of nearly \$2 trillion. We have 17 offices across the United States and over 250 consulting professionals. The Fiduciary Services practice within the firm, which was primarily responsible for this assignment, provides independent assessments, fiduciary and operational reviews and governance advice to its clients.

The “Review Universe” consisted of the global equity, private equity, real estate, credit strategies, and inflation portfolio investments the NCDST entered into between January 2009 and June 30, 2012 (the “Review Period”). The list of investments we reviewed, prepared by the Investment Management Division (IMD), is provided under Tab 1. Although the review was limited in scope, it does provide reasonable assurance that the practices we reflected in our findings are accurate. This review was not an investigation; therefore, it should not be construed as an absolute guarantee that all practices meet fiduciary standards. Our findings and recommendations were based upon information we received from others – primarily the IMD staff and legal counsel – as of the time we performed our work. We did not independently verify all facts, but did seek clarification regarding a number of issues and requested that members of the IMD review the facts we relied upon for our analysis. When conflicts in data were identified we resolved them in favor of using a consistent methodology for benchmarking compliance. The opinions and recommendations expressed in this Report reflect the independent judgment of HEK. No one associated with NCDST attempted to unduly influence the scope, findings, analysis, conclusions, or recommendations expressed in this Report.

This Report highlights where IMD is already exhibiting best practices, identifies compliance gaps when they were found, and provides recommendations designed to strengthen processes and promote best-in-class decision-making oversight, accountability, and transparency. The IMD has already started to implement a number of the recommendations provided in this Report. Examples include the creation of an internal investment committee charter, an investment manager and vehicle selection policy, and a conflict of interest certification form. Where this is the case, it has been noted in a Report footnote.

## **Executive Summary**

The key findings and recommendations generated by this review are summarized below. They are presented in the order in which they occur in the Report, not in order of priority. A summary of all the recommendation in the Report is provided at Tab 5. IMD has already started to implement several of the recommendations. We encourage readers of this Report to examine the narrative associated with each of the key areas.

### **Decision-Making Process and Compliance Gap Analysis**

Overall, we found the IMD's decision-making process and compliance with that process to be sound.

#### **Key Findings**

- The investment decision-making process is founded upon a comprehensive investment policy statement (IPS), adopted by the Treasurer, which is consistent with best practices.
- The soundness of IMD's decision-making process has been advanced by the recent establishment of an internal investment committee. We believe it is an excellent approach used by cutting-edge institutional investors to promote oversight and compliance.
- The IMD is fundamentally in compliance with the IPS requirement to document the basis for each manager selection decision.
- Investment recommendation memos exist for virtually all of the private equity, real estate, credit strategy and inflation protection investments made during the Review Period. Exhaustive legal checklists, as well as summary memorandums, have also been prepared for most of the investment transactions.
- Prior to entering into an investment agreement, execution of a placement agent disclosure letter is required. Disclosure letters are on file for almost all of the investments made during the Review Period. Most of these investments did not involve the use of a placement agent.

## **Recommendations**

Over the last several years, the Treasurer and IMD staffs have worked diligently to institute best practices and distinguish the NCDST as a leading institutional investor. This Report identifies several areas that we believe will assist in this effort, foster continued positive change, add value to the decision-making process and facilitate compliance. The recommendations can be categorized into two primary areas: (1) promoting the Treasurer's ability to fulfill her fiduciary duties and achieve positive long-term returns; and, (2) systemization and strengthening of the documentation related to the investment selection process.

Key recommendations regarding the investment decision-making process are summarized below:

- Seek a statutory amendment to restore the Treasurer's independent contracting authority.
- Establish a compliance certification cover sheet to accompany each investment transaction presented to the Treasurer which certifies that all statutory and policy requirements have been met.
- Develop a systematic process to regularly monitor and report to the Treasurer on policy compliance.
- Create and adopt a charter for the internal investment committee.
- Enhance and consolidate the documentation describing the investment selection decision-making process for each asset class.
- Require the use of investment recommendation memos for all asset classes, including the establishment of a standardized template.
- Consider using asset class consultants to better complement and supplement investment resources.
- Implement a centralized document management system.

## **Investment Manager Fees and Placement Agent Usage**

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

## **Key Findings**

- The fees for virtually all of the global equity managers reviewed are lower than the median for the universe.

- The management fees for most of the credit strategies and inflation protection investments are also below industry comparables; other fee components for these investments are generally below average or are reasonable.
- For private equity and real estate, overall, the fees are reasonable when compared to a universe of comparable investments.
- We found the placement agent fees charged were within the typical range for the applicable asset class. In most cases, the management fees were reduced when a placement agent was used.

### **Recommendations**

- We have no recommendations related to fees.
- With regard to placement agent usage, the disclosure letter should be modified to specify the investment to which it applies.
- The placement agent policy should be amended to specifically require that the disclosure letter will be obtained prior to the agreement execution date.

(This page left blank intentionally)

## **METHODOLOGY**

At the start of the project, HEK provided the NCDST with an extensive document request. The request was designed to obtain the data needed to review existing written policies and guidelines that define the NCDST's investment decision-making authority and processes and examine investment agreements. Examples of information requested included the IPS, investment management agreements, placement agent disclosure letters, etc. The list of documents requested and reviewed is provided at Tab 2.

Following our analysis of the documents provided, interviews were conducted with the Treasurer, key IMD staff, and internal and external legal counsel. At least one representative from the DST's Internal Audit Division was present for most of the interviews. A list of interviewees is provided at Tab 3. The interview process provided an opportunity to evaluate and compare the DST's actual investment practices against written documentation.

We used our extensive knowledge of other sophisticated investors to compare the written investment decision-making policies and functional practices used by the NCDST against common and best practices. We view a "common practice" as a generally accepted way of doing business at other public funds, and a "best practice" as an experience-tested or emerging optimal practice. When forming our conclusions, we take into account that what is an optimal practice for one organization may not be appropriate for another. We also consider the facts and circumstances of each organization and customize our recommendations accordingly.

After identifying the written policies and practices used for investment decision-making, we then conducted a compliance review to determine whether actual practices were in compliance with applicable NCDST requirements. The compliance component of the project focused only on the Review Universe.

Our conclusions concerning the reasonableness of fees are based on the extensive research and knowledge of HEK regarding the fees charged for comparable investments, corroborated by third party industry data. For the non-global equity fee review component of the project, we used an holistic approach. In making our assessment, we did not just look at the actual fees paid. Instead, our review took into

account the various elements of the fee structure, including but not limited to, the investment vehicle, strategy, vintage year, the fee both during and after investment periods, the performance fee, the hurdle rate, administrative expenses, and liquidity.

Drafts of this Report were provided to NCDST for review and comment. Refinements were made and this final Report was delivered to the NCDST on May 22, 2013. It is our hope that this Report's findings and recommendations will add value to the prudent management of the NCRS. We thank each of the NCDST staff members that worked on this project for their diligent efforts.

## I. DECISION-MAKING PROCESS AND COMPLIANCE

### A. “GAP” ANALYSIS

#### 1. Investment Decision-making Policies and Process

The enabling statute and the IPS are the fundamental documents that govern the investment decision-making process of a public fund. We therefore started our analysis of the NCRS investment decision-making process with a review of these documents.

##### a) Statutory Authority

#### FINDINGS

The Treasurer is the sole fiduciary of the North Carolina Retirement Systems (NCRS). The law<sup>1</sup> imposes fiduciary duties on the Treasurer comparable to those prescribed by the Employees Retirement Income Security Act (ERISA), which are the highest standards of conduct under the law. In addition to being subject to a “prudent expert” standard, the Treasurer’s investment decision authority is also subject to statutorily-defined limitations, commonly referred to as a “legal list”.<sup>2</sup> The majority of the state-wide public funds have discarded the use of a “legal list.” Instead, they have moved either to a fiduciary “prudent expert” or “prudent person” standard. Several, however, like North Carolina and the other 3 states that have a sole fiduciary responsible for investments,<sup>3</sup> continue to combine aspects of both.<sup>4</sup> The extent of the limitations imposed varies significantly. The Uniform

---

<sup>1</sup> N.C. Gen. Stat. § 147-69.7

<sup>2</sup> N.C. Gen.Stat. §147-69.2 and 147-69.3. A “legal list” typically defines the types of investment that a fiduciary can make, along with the extent of the investment that can be made in each type of investment.

<sup>3</sup> New York, Connecticut, and Michigan.

<sup>4</sup> Examples of some of the other public funds that continue to be subject to a “legal list” include: Arizona State Retirement System, Public Employees’ Retirement System of Colorado, the Oregon Investment Council, the Tennessee Consolidated Retirement System, the Washington State Investment Board (WSIB), and the State of Wisconsin Investment Board (SWIB),

Prudent Investor Act (UPIA) and the Uniform Management of Public Employee Retirement Systems Act (UMPERSA)<sup>5</sup> do not support the use of legal lists based on the theory that “no particular kind of property or investment is inherently imprudent.”<sup>6</sup> The North Carolina “legal list” provides for 6 separate asset class portfolios.<sup>7</sup> The Treasurer has also adopted policies, guidelines, and processes that further define the investment decision-making framework that is to be used. All investment decisions must comply with the requirements of the statutorily-defined limitations, the fiduciary standards prescribed by statute, and the policies and processes adopted by the Treasurer.

Historically, the Treasurer’s investment decision-making has been exempt from the State’s procurement, review, and fiscal controls.<sup>8</sup> As a result, the Treasurer has had the autonomy to enter into contracts deemed necessary to effectively and efficiently administer the NCRS investment program. The need for a fiduciary to have independent procurement, budgetary, and personnel authority is an industry-recognized best practice.<sup>9</sup> This type of independence mitigates fiduciary risk. Independence is also appropriate because a fiduciary is subject to higher legal standards and they must have the ability to carry out their responsibilities in a prudent manner with undivided loyalty, unfettered by others that are not subject to the same fiduciary standards. Further, fiduciary independence is typically balanced by transparent adherence to documented processes, strict ongoing reporting and oversight. This has been the case for the North Carolina Treasurer.

A systematic contract review process is already being utilized by the NCDST: contract business terms are negotiated by the IMD staff; a model investment contract, with approved legal provisions that have been deemed to be in the best interests of the NCRS, is used by external legal counsel to guide the negotiation of global equity contracts; non-global equity agreements are also reviewed and negotiated by an external law firm using an exhaustive checklist of the Treasurer’s preferred terms. Further,

---

<sup>5</sup> Uniform laws are created by the by Commissioners on Uniform State Laws as an unofficial set of laws proposed for all states to adopt as written to promote uniformity of laws among the states.

<sup>6</sup> See, UPIA § 2 comment at 9 and UMPERSA § 8 comment at 31.

<sup>7</sup> The Fixed Income Portfolio (NCGS §147-69.2(b)(1) – (b)(6b)), the Credit Strategies Portfolio (NCGS §147-69.2(b)(6c)), the Real Estate Portfolio (NCGS §147-69.2(b)(7)), the Public Equity Portfolio (NCGS §147-69.2(b)(8)), the Alternative Investment Portfolio (NCGS §147-69.2(b)(9)), and the Inflation Protection Portfolio (NCGS §147-69.2(b)(9a)).

<sup>8</sup>The Treasurer is exempt from the State’s procurement requirements. N.C. Gen.Stat. 147-68(e) (2009), Article 3 and Article 3C of Chapter 143, and as interpreted by State of North Carolina, Department of Justice, Opinion of the Attorney General, Roy Cooper, December 12, 2002.

<sup>9</sup> See the note to Section 7 of the Uniform Management of Public Employee Retirement Systems Act (UMPERSA).

every quarter the Treasurer must file reports with the Joint Legislative Commission on Governmental Operations, the Chairs of the House of Representatives and Senate Appropriations Committees, the Chairs of the House of Representatives and Senate Finance Committees, and the Fiscal Research Division of the General Assembly. These reports provide transparency and accountability regarding all the investments and deposits made by the NCDST during the prior quarter.

Notwithstanding the contract review and oversight processes already in place, the General Assembly recently granted the Attorney General statutory authority to “review” all service contracts over one million dollars.<sup>10</sup> We were informed that the requirement does not apply to private equity investments. The statute specifies that the “review” is not an approval or disapproval of the policy merit or lack thereof of a proposed contract. Instead, its purpose is to ensure that a contract contains all of the provisions required by law. This requirement could, however, infringe on the Treasurer’s ability to successfully negotiate contractual terms. The Attorney General’s review could, in effect, result in disapproval of a contract if an investment manager is unwilling to accept certain terms. The Treasurer needs flexibility to negotiate contractual terms because select investment managers are often not willing to agree to unilateral terms that they deem are not in their best interest. Managers that have superior performance and are in demand can command more favorable terms. Further, inserting the Attorney General’s review adds additional time to the contracting process. Investment contracts are often time-sensitive. As a result, the Treasurer may be forced to forgo certain investment opportunities.

---

<sup>10</sup> N.C, Gen Stat. § 114-8.3. “Attorney General to review certain contracts. (a) Except as provided in subsection (b) of this section, the Attorney General or the Attorney General's designee shall review all proposed contracts for supplies, materials, printing, equipment, and contractual services that exceed one million dollars (\$1,000,000) to ensure that the proposed contracts are in proper legal form, contain all clauses required by law, are legally enforceable, and accomplish the intended purposes of the proposed contract. The term "review" as used in this section shall not constitute approval or disapproval of the policy merit or lack thereof of the proposed contract. For purposes of this subsection, the term "Attorney General's designee" shall include any attorney approved by the Attorney General to review contracts as provided in this subsection. The Attorney General shall require that any attorney designated under this subsection comply with any rules established by the Attorney General or the Department of Administration regarding the review of contracts. (b) For the constituent institutions of The University of North Carolina, the General Counsel of each institution or the General Counsel's designee shall review all proposed contracts for supplies, materials, printing, equipment, and contractual services that exceed one million dollars (\$1,000,000) to ensure that the proposed contracts are in proper legal form, contain all clauses required by law, are legally enforceable, and accomplish the intended purposes of the proposed contract. The term "review" as used in this section shall not constitute approval or disapproval of the policy merit or lack thereof of the proposed contract. For purposes of this subsection, the term "General Counsel's designee" shall include any attorney approved by the General Counsel to review contracts as provided in this subsection. The General Counsel shall require that any attorney designated under this subsection comply with any rules established by the Attorney General or the Department of Administration regarding the review of contracts.” (2010-194, s. 16; 2011-326, s. 15(p).

## **CONCLUSIONS**

Ideally, the legal list should be eliminated in conformance with UPIA, UMPERSA, and the best practices among public funds. However, given its long-standing application to investments of the NCRS, and the fact that other sole fiduciaries are also subject to legal lists, it is not likely to be done in the short-term.

Allowing the Attorney General to approve investment-related services contracts constrains the Treasurer's fiduciary investment decision-making authority. The Treasurer's fiduciary decision to enter into contracts is supplanted by the authority of a non-fiduciary to the NCRS, the Attorney General. Further, the additional step of the Attorney General's review detracts from the effectiveness and efficiency of the Treasurer's contract review process already in place. Consequently, the new contract approval process is inconsistent with best practice. To be consistent with best practice, all contracts for NCRS goods and services subject to the Treasurer's fiduciary responsibilities should be exempt from the Attorney General's review.

## **RECOMMENDATION**

- Seek a statutory amendment to restore the Treasurer's independent contracting authority.

### **b) The Investment Policy Statement and Related Investment Decision-Making Documents**

## **FINDINGS**

A critical component of an institutional investor's governance framework is a written investment IPS.<sup>11</sup> An IPS defines the parameters of the investment program, including the investor's investment philosophy, objectives and constraints, risk tolerance, return objectives, time horizon, liquidity needs, and investment methodology.

---

<sup>11</sup> The Department of Labor does not require an IPS for ERISA-covered funds. However, the document is viewed as indicia of a prudent process. See, Department of Labor Interpretive Bulletin 29 CFP 2509.94-2. Some state and municipal funds require the adoption of an IPS.

The IPS outlines the roles and responsibilities of the Treasurer, the IMD, and the Investment Advisory Committee (IAC) regarding the management of NCRS investments. The Signatory Authority Policy (SAP), adopted by the Treasurer and revised on November 22, 2011,<sup>12</sup> defines the authority the Treasurer has delegated and what has been retained. It specifically outlines many of the functions the IMD staff may perform on behalf of the Treasurer. The SAP should be read in conjunction with the IPS. When read together, it is clear that the general day-to-day management and oversight of the investment program has been functionally delegated to the IMD, but the Treasurer has retained authority regarding: (1) approval of the investment policy; (2) asset allocation and benchmarks; (3) the selection and termination of investment managers; and, (4) the execution of investment management agreements and limited partnership agreements.<sup>13</sup> It is a common practice for the governing fiduciaries of public funds to retain authority over the IPS and asset allocation. However, in recent years the governing fiduciaries of a number of the larger public funds have started to delegate more authority to their investment professionals including, for example, authority for the search, selection (often up to a threshold amount depending on the asset class) and termination of investment managers.

When the 2008 review of the NCRS investment program was conducted, six separate documents were utilized, each titled “Guidelines, Policies, and Procedures” (the “NCRS Policies”). These documents collectively, in effect, constituted an IPS. The Policies had not, however, been formally approved by the prior or current Treasurer. We concluded in 2008 that, *“while it is not imperative that all the NCRS Policies be consolidated into one comprehensive IPS, such a consolidation would eliminate some redundancies and may be more useful for those who have responsibility beyond one asset class and for those who want an overall understanding of the investment program.”* Since that time, the NCRS Policies have been incorporated into a consolidated investment policy document, the “2012 IPS”, which has been formally approved by the Treasurer.

In Chart A, we review and compare the 2012 IPS against our checklist of the primary components we believe are consistent with best practices. We use the checklist as a benchmark. We note, however, that there is no uniform standard for the content and

---

<sup>12</sup> The SAP provided to HEK in response to its request for documents was dated November 22, 2011. It is our understanding that the SAP has subsequently been updated. A copy of the updated document was not reviewed.

<sup>13</sup> The CIO can execute participation documents for co-investments.

no absolute model to follow. Further, best practices do not require that a standard phrase or specific language be included in an IPS, but rather that processes or definitions are clear and unambiguous to the readers and users of the IPS.

<b>CHART A – INVESTMENT POLICY STATEMENT CHECKLIST</b>	
<b>Subject Matter</b>	<b>Included in the IPS?</b>
<b>Introduction</b>	
Reference to state or local law creating the plan with specific reference to investment-related sections of the law	Yes
Reference to the Board’s (Treasurer’s) right to set policy	Yes
Description of intended beneficiaries of the plan (e.g., the plan is created for certain employees and their beneficiaries)	The different Systems are listed, but a reference to the employees and their beneficiaries is not included
Scope (e.g., limited in application to pension fund assets or may include other assets)	Yes – the policy references the “Fund and ancillary programs”
<b>Statement of Purpose and Duties</b>	
Description of the sole or fundamental purpose of the retirement system	Yes
The standard of care - language describing that plan fiduciaries must act in the sole interest of members and beneficiaries and for the exclusive purpose of providing benefits	Yes
Reference of the duty to incur only reasonable expenses	Not specifically – however, the applicable statute that defines the Treasurer’s duties to the Retirement Systems is cited. It requires “ <i>incurring only costs that are appropriate and reasonable.</i> ” <sup>14</sup> For those unfamiliar with the requirements of the statute, adding the phrase to the IPS may be helpful.
Preserving the actuarial soundness of the plan in order to meet benefit obligations	Yes – “to meet or exceed actuarial assumption”
<b>Investment Goals</b>	

<sup>14</sup> N.C. Gen. Stat, §147-69.7(5).

<b>CHART A – INVESTMENT POLICY STATEMENT CHECKLIST</b>	
<b>Subject Matter</b>	<b>Included in the IPS?</b>
Obtaining a long-term rate of return (one or two market cycles), net of fees, equal to or in excess of the policy benchmark	Yes – while not mentioned explicitly at the total fund level, the investment goal for each asset class is to exceed the benchmark return
Clarification of how investment risks will be managed	Yes
Establishment of the risks that may be taken to achieve return goals	Yes
Definition of the total fund policy benchmark	Yes
<b>Identification of Roles and Responsibilities</b>	
<b>Board of Trustees/Governing Fiduciaries</b> (Treasurer) – general and investment-related duties	Yes <sup>15</sup>
<b>Investment Committee</b> – scope of authority, review and reporting requirements, etc.	Yes – reporting requirements are not specified
<b>Internal staff</b> – general and investment-related duties, reporting lines, and expectations, particularly as among the Executive Director, CIO, and any other senior investment-related staff (e.g., Legal Counsel, Internal Auditor)	Yes
<b>Investment consultant(s)</b> – duties, reporting lines, expectations regarding the frequency of communications, and acknowledgement of fiduciary status	No – the DST does not use a traditional general investment consultant. Specialist investment consultants are used for real estate, private equity, credit strategies, and inflation protection strategies. A description of their role would be informative and promote transparency.
<b>Investment managers</b> – duties, acknowledgement of fiduciary responsibilities, and frequency of communication; could incorporate their contractual mandates	No
<b>Custodian bank</b> – role as custodian or trustee, and role regarding cash management, performance calculations, etc.	No – although the reporting section does specify some reporting requirements of the custodian
<b>Others</b> - Description of other service providers' duties, such as proxy voting or securities lending	No <sup>16</sup>

<sup>15</sup> The role and responsibilities of the Investment Advisory Committee are also included.

<b>CHART A – INVESTMENT POLICY STATEMENT CHECKLIST</b>	
<b>Subject Matter</b>	<b>Included in the IPS?</b>
<b>Asset Allocation</b>	
Acknowledgement of its importance	No – but its importance can be inferred from the rest of the language on asset allocation
Recognition of the allocation’s purpose, such as to provide an optimal mix of investments to produce desired returns and meet current and future liabilities with minimal volatility	Yes
Description of frequency and methodology of asset/liability modeling and allocation resetting	No – asset/liability modeling is not explicitly mentioned; however, asset allocation reviews are required annually and a “detailed analysis” is required every three years
Description of permissible asset classes as well as minimum, maximum, and target ranges	Yes
Standards regarding total fund diversification, including limits to a single issuer, single asset class, economic sector, or country	Yes - included in provisions for asset classes
<b>Asset Class Guidelines and Benchmarks</b>	
Definition of each asset class and rationale for inclusion in the portfolio	Yes
Listing of selected benchmarks and statement of who sets them	Yes – benchmarks are listed in the asset class provisions, the Treasurer’s duty to set benchmarks is included in the Roles and Responsibilities section
Description of any prohibited investments (e.g., short selling, margin, investments precluded by law)	Yes – included in asset class provisions
Overview of allowable credit risk in the portfolio (e.g., minimum credit rating for any fixed income investment as determined by a nationally recognized credit rating agency)	Yes – quality, leverage, and duration is specified in fixed income asset class provisions
Statement of the purpose of rebalancing (i.e., to ensure that the investment program adheres to its strategic asset allocation)	Yes

<sup>16</sup> There are separate proxy voting guidelines and a securities litigation policy. Also, we were informed that a securities lending policy is under development as a separate document. We suggest that the IPS reference any separate investment policies that are critical components of the overall investment program.

<b>CHART A – INVESTMENT POLICY STATEMENT CHECKLIST</b>	
<b>Subject Matter</b>	<b>Included in the IPS?</b>
<b>Rebalancing Policy</b>	
Description of the method used to rebalance (e.g., most cost effective manner, use of excess cash, index strategies as a source, or liquidation of over-funded managers)	Yes
Description of how often the portfolio will be reviewed for rebalancing and whether a fixed threshold or proportional threshold will be used	Yes – language implies ongoing monitoring for rebalancing
<b>Monitoring and Reporting</b>	
Statement of purpose for monitoring and reporting (i.e. to ensure compliance with the IPS and applicable law, to manage risk, and assess manager performance)	No
Description of quarterly reporting for external investment managers; can include an outline of current strategy and investments, performance vs. benchmark, and portfolio composition relative to the asset allocation policy	No – however, reporting from the custodian to monitor performance of the different accounts is described
Identification of Performance Benchmarks – the relative measure to facilitate periodic reporting and gauge performance	Yes – although not highlighted
Purpose and scope of annual and more frequent reporting	No
Requirement to annually review investment policy statement	Yes
<b>Shareholder Activities</b>	
Description of the proxy voting policy and how votes are cast and recorded	Yes
<i>Optional.</i> Statement of the circumstances under which the board will sign on to or initiate a shareholder proposal.	No
<i>Optional.</i> Statement of how (or if) a focus list of underperforming companies will be identified and what communication the board takes to engage companies in dialogue.	No
<i>Optional.</i> Description of the process of opting in and out of shareholder class actions.	No
<i>Optional.</i> Identification of core principles of corporate governance (board independence, CEO compensation, access to the proxy, audit committee, etc.).	No

In addition, the Treasurer has adopted a number of policies designed to promote transparency, accountability, and the highest standard of ethical conduct regarding the investment decision-making process. Key policies include an insider and personal trading policy, a no-contact policy, a supplemental ethics policy, a charitable donations policy, a prohibition on gifts policy, a placement agent policy and a political contribution policy (examined in detail later in the report). The establishment of such policies is consistent with best practices.

## **CONCLUSIONS**

Most of the subject matter we would expect to find in an IPS that is consistent with best practices is addressed in the 2012 IPS. The move to a more consolidated IPS helps to mitigate the risk of redundancies which can occur when multiple policies are used.

It is appropriate for the DST to decide whether or not the components identified as not included in the IPS checklist are needed. We believe, however, that this should be an affirmative decision. For example, the IPS explains why the DST has elected not to use a Fund-wide policy for the sourcing and selection of managers. This type of explanation is an excellent example of acknowledging common practice and explaining why the DST has elected to utilize a different approach.

Each asset class continues to have a distinct section in the IPS. However, a single, integrated IPS is useful for those who have responsibility beyond one asset class and for those who want an overall understanding of the investment program.

The IPS does not provide a statement regarding the process that is to be used to monitor compliance. A process to monitor IPS compliance is a best practice and it would facilitate the Treasurer's ability to ensure that all policies are followed as required by the IPS.<sup>17</sup>

---

<sup>17</sup> DST-INC-POL-1000, Investment Policy Statement for North Carolina Retirement System, November 26, 2012, page 3.

In practice, we believe the IMD staff understands their respective roles and investment responsibilities in the decision-making process. They recognize the benefits and are committed to the policies the Treasurer has adopted which promote transparency, accountability, and high ethical standards. Based on the interview process, however, we concluded that a number of IMD staff members are not familiar with the specifics of some of these policies, such as the details of the Signatory Authority Policy or the application of the no-contact policy.<sup>18</sup> For example, although the language of the No Contact policy appears to include all staff within the IMD, we were told by some during the interview process that the policy does not apply to the IMD staff when they are engaged in the selection of investments. Periodic training sessions and testing on the policies of the DST would advance the IMD staff's awareness and is consistent with the best practices of large institutional investors.

## **RECOMMENDATIONS**

- Develop a systematic process to regularly monitor and report on policy compliance to the Treasurer.<sup>19</sup>
- Clarify the application of the no-contact policy.
- Conduct in-house training and periodic testing to ensure that the IMD and investment operations and accounting staff are familiar with applicable investment policies and practices.

---

<sup>18</sup> The No Contact Policy was adopted March 1, 2010. The Policy prohibits communication or contact upon the announcement of a Request for Proposal, an Invitation for Bid, a formal due diligence, etc.

<sup>19</sup> This recommendation was in the 2008 Report.

## 2. STEPS IN THE INVESTMENT DECISION-MAKING PROCESS

### FINDINGS

It is typical for the steps in the decision-making process to vary somewhat depending on the asset class. However, there are certain common elements in the documentation of the process, such as clarity of roles and consistency that are needed to mitigate governance and operational risk.<sup>20</sup>

Multiple documents are used by the IMD to prescribe its investment decision-making including the IPS, the SAP, and a document entitled, “The Equity Investment Process Description”.<sup>21</sup> It is clear from the documentation reviewed and the interviews that the Treasurer has retained investment decision-making approval authority for all of the asset class portfolios in which the NCDST invests except, to some degree, for the fixed income investment portfolio. The fixed income portfolio is managed internally. Development and implementation of trading strategies have been delegated to the Director of Fixed Income.<sup>22</sup> The investment parameters of the fixed income portfolio are still subject to the IPS, which the Treasurer must approve.

Documents reviewed indicated that the CIO is responsible for overall portfolio investment strategy, and asset class directors are responsible for overseeing the investment strategy, manager selection and operational issues.<sup>23</sup>

Chart B-1 is a copy of a diagram developed by the IMD. Chart B-2 is a copy of an IMD flow-chart which reflects the steps in the private markets investment process. Both charts were presented to the IAC in early 2012 to illustrate IMD’s investment decision-making process. The Equity Investment Process Description, which also describes the fundamental investment approval process, is not consistent with Charts B-1 or B-2.

---

<sup>20</sup> See, *APPFA Public Pension Systems Statements of Key Risks and Common Practices to Address Those Risks*, July 2000. “Governance risk” is the risk of loss due to the board, staff, or service providers, either intentionally or unintentionally, through their management actions or lack thereof, causing the assets of the System to under- perform expectations. “Operational risk” is the risk of loss (monetary and non-monetary) from inadequate or failed processes, people and systems or from external events.

<sup>21</sup> The document is not dated.

<sup>22</sup> North Carolina Department of State Treasurer Statement of Policy, Signatory Authority Policy.

<sup>23</sup> Investment Advisory Committee minutes of February, 2012.

Chart B-1 reflects the recently created Internal Investment Committee. A number of large sophisticated public fund investment entities use this approach.<sup>24</sup> We find that the use of an internal investment committee, with clearly documented roles and responsibilities, by large complex investment entities is a best practice. The Internal Investment Committee was described to the IAC as a “...three-legged stool, comprised of (1) risk, (2) operations, and (3) investment review.... The CIO and all directors are members of the committee and any one person can stop an investment from moving forward.”<sup>25</sup> However, during the interview process, we found there was a lack of clarity regarding whether the IMD’s internal investment committee was a formal or informal group, the specific role of the committee, and the authority of the members of the committee (e.g. whether any one member has veto authority over an investment).

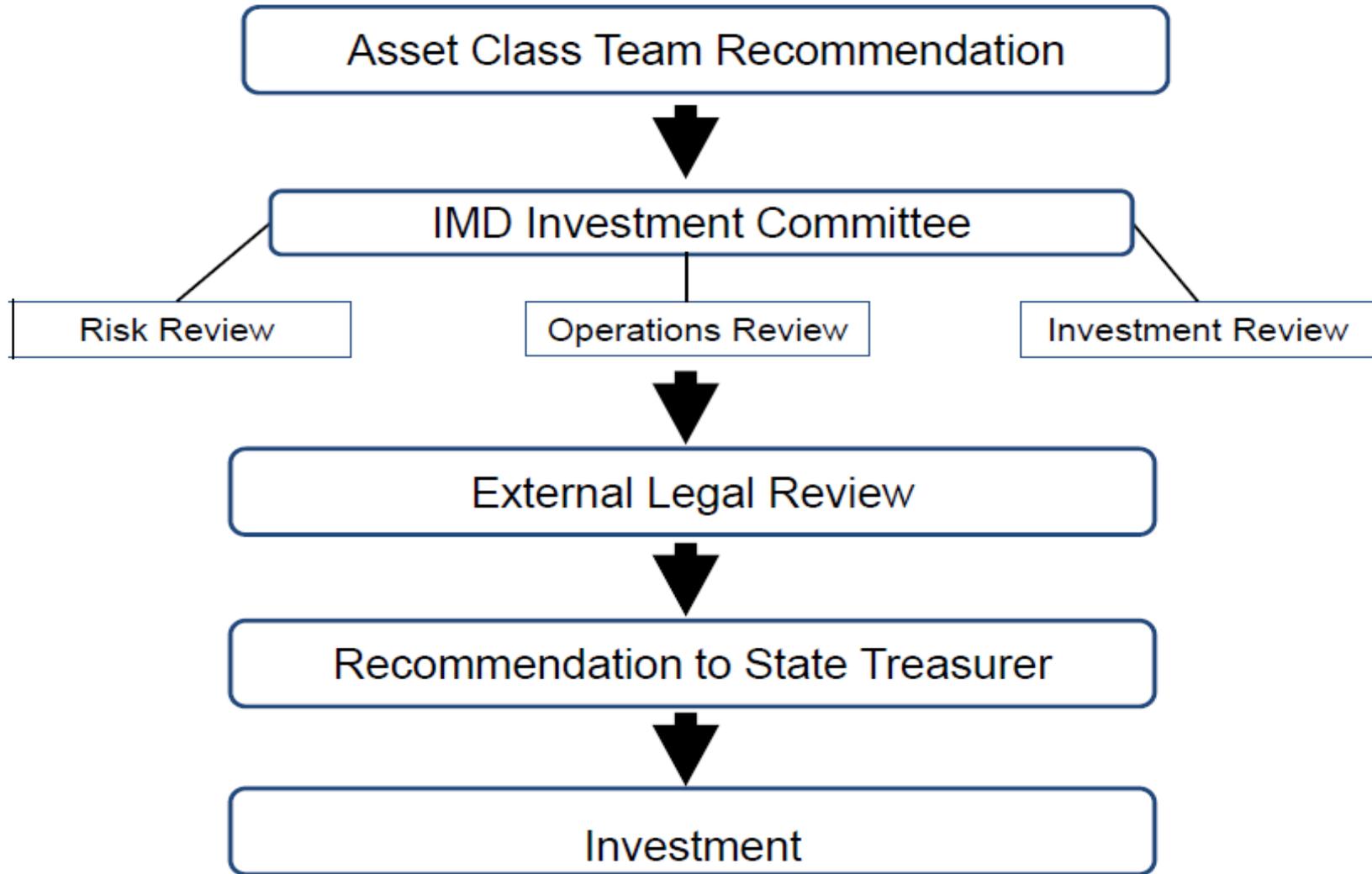
---

<sup>24</sup> Examples include the Texas Teacher Retirement System, the State of Wisconsin Investment Board, the Nebraska Investment Council, and the Caisse de Depot. In each of these cases, authority over the selection and termination of investment manager, subject to certain dollar parameters, has been delegated from the governing fiduciaries to the investment staff.

<sup>25</sup> Minutes of the Investment Advisory Committee meeting of September 21, 2011.

Chart B-1

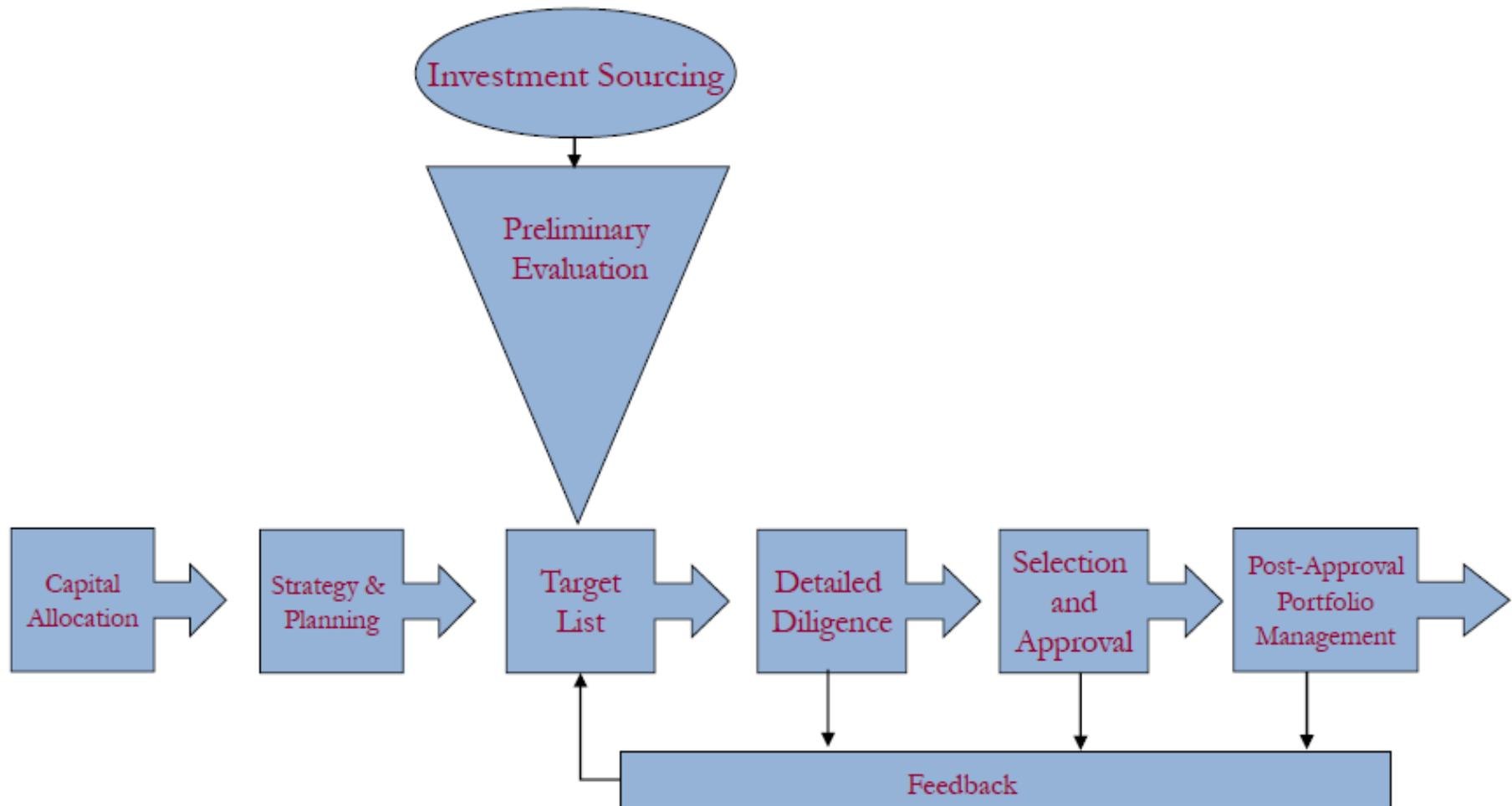
# Investment Approval Process



<sup>26</sup> 9/21/2011 NDCST Presentation to IAC

Chart B-2

# Due Diligence and Investment Process



## **CONCLUSIONS**

The IMD is to be applauded for the establishment of an internal investment committee which is consistent with best practices.

The current investment decision-making process has not been detailed in a formal written policy. Defining the respective roles and responsibilities of all key parties, including the internal investment committee, and the systematic steps in the investment decision-making process for each asset class in a formal written document would assist the NCDST in mitigating governance and operational risk.

Our earlier recommendation regarding training would also facilitate a comprehensive knowledge of the process among the members of the IMD staff.

## **RECOMMENDATIONS<sup>27</sup>**

- Adopt a charter for the internal investment committee that defines its purpose, authority, and composition.
- Enhance and consolidate the written documentation describing the investment decision-making process for each asset class.

---

<sup>27</sup> The IMD has already started to implement both of these recommendations. In February, 2013 the IMD provided HEK with drafts of an internal investment committee charter and an investment manager and vehicle selection policy.

### 3. DOCUMENTATION OF INVESTMENT SELECTION DECISION

#### FINDINGS

The IPS requires that the IMD staff document the basis for each manager selection decision on a search-by-search basis.<sup>28</sup> Various documents, described below, are used to substantiate the process the IMD staff engages in when selecting a manager.

The IMD staff prepares many of the documents that are used for purposes of the decision-making process. The NCDST uses specialty consultants for alternative asset classes; however their use varies by asset class and by deal. External legal counsel is used extensively for alternative asset classes. Internal legal staff has minimal participation in the investment decision-making process.

The following is a list of the documents IMD uses to document the basis for investment decision-making for asset classes other than global equities and fixed income:

- **Due Diligence Memos:** The IMD has recently started to prepare a pre-due diligence report and/or a preliminary due diligence report. The pre-due diligence report is prepared internally and has the following eight sections: (1) recommendation<sup>29</sup>; (2) fund overview & key terms<sup>30</sup>; (3) potential fit within NCRS portfolio<sup>31</sup>; (4) overview & background<sup>32</sup>; (5) investment strategy<sup>33</sup>; (6) management section;<sup>34</sup> (7) track record summary<sup>35</sup>; and (8) investment process.<sup>36</sup> The preliminary due diligence report is very similar to the pre-due diligence report. It contains a section that addresses the comments,

---

<sup>28</sup> Page 7 of the IPS, in the section entitled *Selection and Monitoring of Investment Managers*.

<sup>29</sup> The asset team gives its recommendation along with the rationale for a potential investment in the fund.

<sup>30</sup> An overview of the investment fund including key terms for the fund.

<sup>31</sup> An analysis of how the potential investment fund will fit and what it will provide for the overall NCRS portfolio.

<sup>32</sup> An overview and background of the potential investment fund.

<sup>33</sup> An investment strategy overview, including information regarding the expected investment profile and portfolio characteristics, reserve management, use of debt at the Fund level, and the General Partner's competitive positioning.

<sup>34</sup> A list of the senior investment team, along with their biographies for the possible fund and information regarding the firm ownership.

<sup>35</sup> A summary of the track record for the potential investment fund including information regarding fund-level performance, company-level performance, sector analysis, domicile analysis, concentration analysis, partner attribution, vintage year analysis, and summary.

<sup>36</sup> Information regarding the investment process, including an overview of the process, sourcing of new investments, the due diligence and investment committee, and exits.

questions and concerns of the Internal Investment Committee, but does not have a recommendation section. Both documents are used primarily to introduce the investment and vet interest before expending additional time and resources. It is not standard practice for the IMD to use these due diligence memos. Therefore, we do not consider them for purposes of assessing compliance.

- **Investment Recommendation Memo:** We found several versions of this document. One version of the document is one to two pages long and is created for the internal Investment Committee. This shorter memo typically includes an overview of the potential investment fund, the key terms for the fund, the status of fund raising and a recommendation summary. Some of the shorter memos also included a section on the fit of the possible investment fund within the NCRS portfolio. Most of these shorter memos were prepared for real estate investments.

Other investment recommendation memos are very comprehensive and typically include the following subject matter: (1) term-sheet and fundraising status; (2) recommendation summary; (3) thesis for a midstream and downstream focused manage; process; (4) fit within the NCRS Portfolio; (5) manager summary; (6) action items; and, (7) an appendix.

- **Final Checklist:** This document is comprised of a standardized set of 92 items. It is prepared as part of the manager selection and contract negotiation process for asset classes other than global equities and fixed income.<sup>37</sup> The document was developed by external legal counsel, Womble Carlyle Sandridge & Rice (Womble Carlyle). It is a review of the essential items that are considered for non-equity investments, including whether and how the Treasurer's preferred terms and conditions are addressed. For purposes of real estate investments, the staff also used a closing binder checklist.
- **Summary Memo:** This document is also prepared by external legal counsel, typically Womble Carlyle. It provides a synopsis of the investment contract terms to which the parties have agreed. We were informed that this document is provided after the closing.

---

<sup>37</sup> The Final Checklist is not used for global equity investments.

- **Risk Management Memo:** A Director of Risk Management position was created in 2011. Subsequent to the establishment of the position, a Risk Management Memo was added to the investment decision-making process. The memo contains: (1) an investment overview; (2) NCRS portfolio construction i.e., how the investment fits within the NCRS portfolio; and, (3) Comments. The investment overview identifies the asset class team recommending the investment, the amount of the investment, and narrative regarding the following elements of the investment: (a) its goal; (b) focus; (c) sectors; (d) geography; (e) the degree of leverage; (f) the portfolio company concentration; (g) the investment's term; (h) the investment team; (i) past performance; and, (j) any special considerations.

During the interview process, we were informed by several interviewees that a discussion of whether an investment is permitted by statute and is consistent with the IPS is part of the investment process. However, an acknowledgement of statutory and IPS compliance is not addressed in any of the due diligence documents reviewed (e.g. the recommendation memo or the checklist).

Currently, there is no policy or checklist that specifies the specific documentation needed to evidence the due diligence process (e.g., due diligence memo, summary memo, transaction compliance checklist).

The contents of the checklist and summary memo prepared by external legal counsel are generally consistent; however, the form and content of the other due diligence documents (e.g. the investment recommendation memo) are not.

## **CONCLUSIONS**

We believe that ensuring that an investment is consistent with statutory and policy requirements is always a consideration of the IMD. However, none of the investment due diligence documents we reviewed contained a section that specifically addresses whether the proposed investment is in compliance with the statute or applicable policies. A checklist, with an affirmation, that confirms to the Treasurer that all the requirements related to an investment have been met prior to approval is particularly

important since fiduciaries are judged by the prudence of their process.<sup>38</sup> It would also be in line with what we believe to be best practice.

Compilation of the documentation related to the decision-making process for each investment made by the NCDST was challenging. Establishing a centralized investment document log and filing system would facilitate the IMD's ability to better assess compliance, substantiate that a thorough due diligence process was effectuated, and mitigate the risk of missing, lost, or conflicting data.

The IMD's ability to document the basis for investment decisions is hampered because it is very resource constrained. One way to address the lack of internal resources is either to hire additional staff within the IMD and/or make better use of its asset class investment consultants, using them as extensions of staff.

The form and content of the due diligence documents used by the IMD should be standardized, with required subject matter for each asset class memo. The following is a list of suggested additional content. Some of the information suggested below was found in some memos, but not in others.

- (1) a section that specifically addresses whether the investment is in compliance with statute and the IPS;
- (2) a SWOT<sup>39</sup> analysis (currently it appears that this information is often disbursed throughout a memo rather than being presented in a distinct section; if the current practice is continued, we suggest having a SWOT summary);
- (3) a summary of the due diligence performed by the IMD (e.g. documents reviewed, meetings held and with whom, dates actions/steps in the process were completed); and
- (4) sections that outline the following issues:

---

<sup>38</sup> Donovan v. Cunningham, 716 F.2d 1455 (5<sup>th</sup> Cir. 1983)

<sup>39</sup> SWOT means strengths, weaknesses, opportunities, and threats.

- i. other limited partners (LPs) in the funds the general partners have raised and an analysis of the types of LPs in the funds (public, corporate, Endowment & Foundation, high-net-worth, etc.);
- ii. market opportunity;
- iii. detailed performance attribution;
- iv. reference checks; and,
- v. any litigation issues.

During the review process we learned that internal legal counsel is only minimally involved in the investment decision-making and compliance process. We understand there are resource constraints in the legal area. Nonetheless, in our experience internal legal counsel is often more involved in the investment transactions process, particularly as it relates to contract negotiation and coordination of the use of external legal counsel.

## **RECOMMENDATIONS**

- Develop a document that defines the required steps in the investment decision-making process for each asset class, including the specific documents that must be produced to verify the rationale for investing.<sup>40</sup>
- Develop a charter for the internal investment committee.<sup>41</sup>
- For each asset class, create a standardized due diligence/investment recommendation memo template, including the minimum content each report should address.
- Develop a compliance checklist cover sheet to accompany each investment that is presented to the Treasurer.<sup>42</sup>
- Consider using asset class investment consultants to better complement and supplement IMD's investment resources.
- Engage internal legal counsel more in the investment decision-making coordination and documentation process.
- Provide the Summary Memo prior to the closing date for an investment.
- Establish a centralized log and filing system for investment due diligence and participant documents.

---

<sup>40</sup> The IMD had already started to implement this recommendation

<sup>41</sup> A sample internal investment committee charter has been provided to the NCDST. As noted earlier, the IMD has already drafted an internal investment committee charter,

<sup>42</sup> A suggested template is provided at Tab 4.

(This page left blank intentionally)

## **B. COMPLIANCE REVIEW**

### **FINDINGS**

The IPS requires that the Treasurer ensure all policies are followed<sup>43</sup> and that the IMD staff “document the basis for each manager selection on a search-by-search basis.”<sup>44</sup> Documentation is required because it is the philosophy of NCDST that preparing a comprehensive, Fund-wide policy for the sourcing and selection of managers is not feasible because the nature of the investment mandates for each portion of the portfolio are so different.<sup>45</sup>

Bloomberg Pretrade is used for fixed income internal accounts compliance with segregation between the portfolio managers and the traders. BNY/Mellon is used for compliance on the Angelo Gordon fixed income portfolio. A review of the fixed income decision-making compliance was not within the scope of this project.

### **GLOBAL EQUITIES**

There were 16 global equity investments made during the Review Period. They are listed below.

1. BlackRock Frontier Markets
2. BlackRock Emerging Markets
3. Mondrian Emerging Markets Equity
4. MCM Large Cap Passive
5. MCM Mid Cap Passive
6. Wellington Mid Cap Opportunities
7. BlackRock ACWI ex US IMI

---

<sup>43</sup> DST-INC-POL-1000, Investment Policy Statement for North Carolina Retirement System, November 26, 2012, page 3.

<sup>44</sup> DST-INC-POL-1000, Investment Policy Statement for North Carolina Retirement System, November 26, 2012, page 6

<sup>45</sup> Id.

8. Mondrian International Small Cap
9. Franklin Templeton International Small Cap
10. Wellington Large Cap Value
11. RhumbLine Russell 200 Passive
12. BlackRock MSCI EAFE IMI
13. BlackRock MSCI Canada
14. BlackRock MSCI ACWI ex-US SC
15. Gladius Aconcagua
16. Tiger Tar Heel Partners

A recommendation memo, checklist or summary memo is typically not used for global equity investments<sup>46</sup>. A model contract of preferred terms is used by external legal counsel as the starting point for contract negotiations. There is no document for global equities that identifies when and why exceptions to the preferred terms were made.

For global equities, the staff uses a request for information as the initial screen in the investment manager selection process. Following the initial screen, a request for proposal (RFP) is used to conduct an in-depth analysis. Based on the RFP responses, two to three prospective managers are selected for on-site due diligence visits. After the on-site visits, since early 2011, a recommendation is made by the Global Equity Team to the newly created Internal Investment Committee. A recommendation is then presented to the Treasurer which incorporates the comments of the Internal Investment Committee.

---

<sup>46</sup> Investment recommendation memos were provided for 3 of the 16 global equity investments made during the Review Period – Wellington Large Cap Vaule, Gladius Aconcagua, and Tiger Tar Heel Partners.

To review compliance with the investment decision-making process for asset classes other than global equities and fixed income investments, we used the following three documents: (1) the investment recommendation memo, (2) the final checklist, and (3) the summary memo. We considered the investment recommendation memo as the primary document necessary to demonstrate compliance with the IPS documentation requirement; the others two documents, although important, were viewed as supplemental.

Chart C reflects our compliance findings by asset class. Missing documents are highlighted.

**PRIVATE EQUITY**

<b>Chart C-1: Compliance Review Process</b>			
<b>Fund Name</b>	<b>Investment Recommendation Memo</b>	<b>Final Checklist</b>	<b>Summary Memo</b>
<b>Private Equity</b>			
1. Credit Suisse Innovation Fund	X	X	X
2. Harvest Partners VI	✓	✓	✓
3. Vista Equity Partners Fund IV	✓	✓	✓
4. Tenaya Capital VI	✓	✓	✓
5. Oaktree European Principal Fund III	✓ <sup>47</sup>	X	X
6. Mount Kellet Capital Partners II	✓ <sup>48</sup>	X	X
7. Accel-KKR Capital Partners IV	X	X	✓
8. New Enterprise Associates 14	X	✓	✓

<sup>47</sup> Credit Suisse prepared the investment recommendation memo.

<sup>48</sup> An initial comments list was also prepared.

## REAL ESTATE

<b>Chart C-2: Compliance Review Process</b>			
<b>Fund Name</b>	<b>Investment Recommendation Memo<sup>49</sup></b>	<b>Final Checklist<sup>50</sup></b>	<b>Summary Memo</b>
<b>Real Estate</b>			
1. RREEF Global Opportunities Fund II, Senior Notes	✓	X	X
2. AG Asia Realty Fund II	✓	X	X
3. AG Net Lease Realty Fund II	✓	X	✓
4. SRI Ten REIT	✓	✓	✓
5. CrossHarbor Institutional Partners II	✓	✓	✓
6. NorthCreek Fund	✓	X	X
7. Patria Brazil Real Estate Fund II	✓	✓	✓
8. DRA Growth & Income Fund VII	✓	✓	✓
9. Lone Star Real Estate Partners II	✓	X	✓
10. Harrison Street Real Estate Partners III	✓	✓	✓
11. Blackstone Real Estate Partners VII	✓	X	✓
12. WCP Real Estate Fund III(A)	✓	✓	✓
13. Brookfield Real Estate Finance Fund III	✓	✓	✓
14. Scout Fund II	✓	✓	✓
15. Northrock Fund II	✓	X	X
16. Rockwood Capital Fund IX	✓	X	✓
17. Rockpoint Real Estate Fund IV	✓ <sup>51</sup>	✓	X

<sup>49</sup> Comprehensive investment recommendation memos are typically prepared by the real estate consultant. Staff often also prepares an abbreviated memo.

<sup>50</sup> A closing binder checklist is also used for real estate investments. We were informed that final checklists are in the closing binders for all real estate investments.

<sup>51</sup> A risk management memo was also prepared for this investment.

## **CREDIT STRATEGIES**

<b>Chart C-3: Compliance Review Process</b>			
<b>Fund Name</b>	<b>Investment Recommendation Memo</b>	<b>Final Checklist</b>	<b>Summary Memo</b>
<b>Credit Strategies</b>			
1. AG TALF Partners	X	✓	✓
2. AG GECC Public-Private Investment Fund	✓	✓	✓
3. WLR IV PPIP Co-Invest	✓	X	✓
4. PAAMCO-Newport Burgundy	✓	X	✓
5. Anchorage Capital Partners	✓	X	X
6. Citadel Residential Mortgage Opportunities Fund	✓	✓	✓
7. Brigade LCS Fund	✓	✓	✓
8. Monarch Debt Recovery Fund	✓	X	✓
9. CVI Credit Value Fund	✓	✓	✓
10. Varde Fund X	✓	✓	✓
11. Saba Capital Partners	✓	✓	✓
12. Claren Road Credit Fund	✓	✓	✓
13. Oaktree Value Opportunities Fund	✓	X	X
14. GSO Capital Opportunities Fund II	✓	✓	✓
15. Fortress Credit Opportunities Fund III	✓	✓	✓
16. Intervale Capital	✓	✓	✓

## INFLATION PROTECTION

<b>Chart C-4: Compliance Review Process</b>			
<b>Fund Name</b>	<b>Investment Recommendation Memo</b>	<b>Final Checklist</b>	<b>Summary Memo</b>
<b>Inflation Protection</b>			
1. Energy Capital Partners II	✓	X	✓
2. Sheridan Production Partners II	✓	✓	✓
3. Gresham TAP Flex	✓	X	X
4. EnCap Energy Capital Fund VIII	✓	✓	X
5. Vermillion Celadon	✓	✓	✓
6. Credit Suisse Enhanced	✓	X	X
7. Blackstone Resources Select	✓	✓	✓
8. ArcLight Energy Partners Fund V	✓	✓	✓
9. Energy Capital Partners II (Summit Co-Invest)	✓	X	X
10. EIF US Power Fund IV	✓	✓	✓
11. EnCap Energy Capital Fund VIII Co-Invest	✓	X	X
12. Perella Weinburg Partners ABV Opp Fund III	✓	✓	✓
13. Denham Commodity Partners Fund VI	✓	✓	✓
14. RK Mine Finance Fund II	✓	✓	✓

## **CONCLUSIONS**

As Chart C reflects, the IMD has been diligent in its preparation of investment recommendation memos. Memos were prepared for almost all of the alternative investments made during the Review Period -- only 4 were missing. Final checklist and summary memos were not found for several of the investments; however, while these documents are considered important, they are supplemental to the investment recommendation memo. Further, it is possible that the documents exist, but were not found because there is not a centralized log and filing system.

Substantiating the rationale for the investment selection decision is a best practice. We found the documentation used by the IMD for non-global equity investments to be generally in compliance with best practices.

To comply with the requirement of the IPS, the basis for the selection of global equities managers should parallel the written documentation used for alternative investments (e.g. private equity, real estate, etc.).

## **RECOMMENDATIONS**

- Establish a process to ensure that, prior to funding, the basis for each investment decision is documented in compliance with the requirement of the IPS.
- Include a section in the due diligence memo, the recommendation memo, and the checklist that specifically acknowledges that the investment is in compliance with statutory requirements, the IPS, and other applicable policies that have been approved by the Treasurer or established by the IMD CIO.
- Improve the investment decision documentation for global equity investments, including: (1) ensuring that a recommendation memo is prepared; and, (2) using a checklist and/or summary memo comparable to the documentation used for other asset classes.

(This page left blank intentionally)

## II. REVIEW OF PLACEMENT AGENT USAGE AND INVESTMENT MANAGER FEES

### A. PLACEMENT AGENT REVIEW

The use of placement agents has been an area of controversy in the investment industry. Placement agents are most often used for alternative investments, typically private equity, rather than public market investments. Their functions and fees vary greatly which has further fueled the controversy. To reflect best practice, the duties and fees of a placement agent should be set forth in a written agreement.

The fees paid to a placement agent are typically calculated as a percentage of the capital raised that is attributable to the efforts of the placement agent. There is no standardized fee or fee structure; third-party industry research reflected fees from 1% to 5%. In our experience, fees tend to range from 1% to 2.5% for private equity and 1% to 2% for real estate. Placement agent compensation agreements may also include a bonus structure.

To address concerns around the use of placement agents, many public funds have adopted placement agent policies that are designed to mitigate the risk of abuse and corruption. The Treasurer first approved the NCDST Placement Agent Policy on September 29, 2009. Subsequent to its adoption, the SEC adopted a rule which prohibits investment advisers from: (1) using third-party intermediaries (e.g. placement agents) to market to public funds unless they are either registered investment advisers or registered broker-dealers; (2) receiving compensation for advisory services it provides to a “government entity” within two years following a “contribution” to an “official” of the government entity; and, (3) coordinating or soliciting contributions to certain officials of public funds or to political parties of a state or locality where the adviser is providing or seeking to provide advisory services to a public fund.

The Treasurer approved a revised policy, entitled NCDST Placement Agent and Political Contribution Policy (Policy), on March 14, 2011. The 2011 Policy, like the prior policy, provides eligibility criteria, requires disclosures, and sets forth remedies for violations.

The Policy incorporates the tenets of the SEC prohibition on “pay to play” and specifically affirms that all investment recommendations and decisions must be based solely on the merits after necessary due diligence.

The Policy specifies that the required Disclosure Letter must be provided by an investment manager “*prior to entering into an agreement to engage, hire, invest with or commit to invest, or otherwise do business with the Treasurer.*” The appropriate date to be used to comply with this requirement is subject to interpretation. We used the closing date provided by IMD rather than the contract execution date as the compliance point.<sup>52</sup> The policy did not require a disclosure letter from existing managers. However, the policy does apply prospectively to any changes to the agreement of an existing manager (e.g. contract amendments, increased commitments, etc.).

There is no requirement that the investment manager disclosure letter specify the name of the fund for which it is being made. This can cause issues because the NCDST often has multiple investments with the same investment manager. The Policy also does not contain language that authorizes the negotiation of an exception to any of the requirements contained in the policy. In our experience having that flexibility is desirable.

Chart D identifies, by asset class, the investments during the Review Period, the closing date of the investment, whether the required disclosure letter was provided, the date of the letter, and whether the investment manager used a placement agent.<sup>53</sup> If a placement agent was used, the chart also reflects the fee terms. Investments where the disclosure letter was dated after the investment closing date are highlighted. Disclosure letter dates are bolded if they were not executed proximate to the closing date.

---

<sup>52</sup> For global equities the closing date is the date the account was funded.

<sup>53</sup> The methodology for benchmarking placement agent policy compliance that HEK used includes: (1) the data identified in the document provided by IMD at the start of the project which identified the investments made during the Review Period and the closing dates for each (see Tab 1) and (2) the execution dates on the placement agent forms provided in response to the document request. This methodology resulted in differences in the dates used in the Report and the information provided in a spreadsheet received from IMD on May 12, 2013.

## 1. Global Equity

Chart D-1: Global Equity Fund Name	IMD Reported Closing Date	Was a disclosure letter provided	Disclosure Letter Date On Form Provided	Was a Placement Agent Used
BlackRock Frontier Markets	4/1/2009	Y <sup>54</sup>	12/12/2009 <sup>55</sup> 9/02/2010 <sup>56</sup> 4/06/2011 <sup>57</sup>	N
BlackRock Emerging Markets	6/1/2009			
BlackRock MSCI EAFE IMI	4/29/2011			
BlackRock MSCI Canada				
BlackRock MSCI ACWI ex-US SC				
BlackRock ACWI ex US IMI	9/9/2010			
Franklin Templeton International Small Cap	9/9/2010	Y	8/13/2010	N
Gladius Aconcaqua	9/26/2011	Y	9/22/2011	N
MCM Large Cap Passive	4/1/2010	Y <sup>58</sup>	7/13/2010	N
MCM Mid Cap Passive				
Mondrian Emerging Markets Equity	11/27/2009	Y <sup>59</sup>	10/26/2009	N
Mondrian International Small Cap	9/9/2010			
RhumbLine Russell 200 Passive	4/29/2011	Y	4/5/2011	N
Tiger Tar Heel Partners	4/18/2012	Y	4/15/2012	N
Wellington Mid Cap Opportunities	4/9/2010	Y	7/9/2010	N
Wellington Large Cap Value	4/29/2011	Y	4/5/2011	N

<sup>54</sup> Separate forms were not provided for each of the BlackRock Investments.

<sup>55</sup> Disclosure letter date 12/17/2009. Execution date of letter was 12/12/2009,

<sup>56</sup> Form specifies that it is for CARS investment

<sup>57</sup> The form was executed by one managing director on April 5, 2011 and one on April 6, 2011. We used the later date for purposes of the execution date.

<sup>58</sup> A form was executed, but separate forms were not provided for each of the investments.

<sup>59</sup> A form was executed, but separate forms were not provided for each of the investments.

## 2. Private Equity

Chart D-2: Private Equity Fund Name	IMD Reported Closing Date	Was a form executed	Disclosure Letter Date On Form Provided	Was a Placement Agent Used	Fee Structure	Placement Fee Terms
Accel-KKR Capital Partners IV	3/16/2012	Y	3/15/12	N		
Credit Suisse Innovation Fund	<b>2/23/2010</b>	Y	<b>4/19/11</b>	N		
Harvest Partners VI	9/28/2011	Y	9/22/11	Y <sup>60</sup>	0.6% on first \$750M of capital raised, 1.2% thereafter	Management fees reduced by placement fees paid by the partnership
Mount Kellet Capital Partners II	<b>2/15/2012</b>	Y	<b>2/16/2012</b>	Y <sup>61</sup>	2.5% on capital raised	Placement agent fees paid by the management company
NEA 14	5/18/2012	Y	4/26/2012	N		
Oaktree European Principal Fund III	12/7/2011	Y	12/7/2011	Y <sup>62</sup>	Placement agent is an Oaktree entity and is compensated at actual costs + 10%	Management fees reduced by placement fees paid by the partnership
Tenaya Capital VI	11/15/2011	Y	11/8/2011	Not for NC <sup>63</sup>		
Vista Equity Partners Fund IV	10/28/2011	Y	10/28/2011	Not for NC <sup>64</sup>		For funds where a PA was used the management fees for any given LP reduced by any placement agent fees paid by the partnership in relation to that LP's subscription

<sup>60</sup> Private Fund Group of Credit Suisse Securities (USA) LLC.

<sup>61</sup> BTIG, LLC.

<sup>62</sup> OCM Investments, LLC.

<sup>63</sup> The placement agent was not used for pre-existing investor's in prior funds managed by Tenaya Capital.

<sup>64</sup> The firm indicated that they did not use a placement agent for North Carolina, but they did use a placement agent for the Fund.

### 3. Real Estate

Chart D-3: Real Estate Fund Name	IMD Reported Closing Date	Was a form executed	Disclosure Letter Date On Form(s) Provided	Was a Placement Agent Used	Fee Structure	Placement Fee Terms
AG Asia Realty Fund II – Angelo Gordon	7/30/2010	Y		N		
AG Net Lease Realty Fund II - Angelo Gordon	7/30/2010	Y	7/27/2010 <sup>65</sup>	N		
Blackstone Real Estate Partners VII	8/15/2011	Y	8/02/2011	Y <sup>66</sup>		
Brookfield Real Estate Finance Fund III	12/30/2011	Y	1/10/2012	Y <sup>67</sup>		Placement agent fees to be paid by partners and are excluded from any management fee offset
CrossHarbor Institutional Partners II	12/23/2010	Y	12/02/2010 12/17/2010	Y <sup>68</sup>	0.5% of first \$100m 0.4% of next \$100m 0.3% of next \$100m 0.2% of next \$100m 0.1% above \$400m	LPA not executed Placement agent fees appear to be the responsibility of the GP
DRA Growth & Income Fund VII	5/09/2011	Y	5/4/2011	N		
Harrison Street Real Estate Partners III	6/06/2011	Y	6/03/2011	N		
Lone Star Real Estate Partners II	5/26/2011 <sup>69</sup>	Y	5/24/2011	N		
NorthCreek Fund	1/31/2011	Y <sup>70</sup>	12/10/09	N		
Northrock Fund II	6/15/2012			N		
Patria Brazil Real Estate Fund II	3/31/2011	Y	Not Dated <sup>71</sup>	Y <sup>72</sup>	2.0% of capital raised up to \$200m 3.0% of capital raised above \$200m	Signed but not dated Placement agent fees stated as the responsibility of the GP

<sup>65</sup> Document indicates that one form was executed for both investments.

<sup>66</sup> Park Hill Real Estate Group LLC.

<sup>67</sup> Brookfield Private Advisors LLC.

<sup>68</sup> Real Estate Private Fund, Group of Credit Suisse Securities (USA) LLC.

<sup>69</sup> Agreement provided was not dated or executed.

<sup>70</sup> A form was executed, but separate forms were not executed for each of the investments.

<sup>71</sup> We were informed that an update was sent 4/18/2011.

<sup>72</sup> M3 Capital Partners LLC.

Chart D-3: Real Estate Fund Name	IMD Reported Closing Date	Was a form executed	Disclosure Letter Date On Form(s) Provided	Was a Placement Agent Used	Fee Structure	Placement Fee Terms
Rockpoint Real Estate Fund IV	6/18/2012	Y	5/17/2012	N		
Rockwood Capital Fund IX	6/15/2012	Y	6/13/2012	N		
RREEF Global Opportunities Fund II, Senior Notes	7/11/2010	Y	7/__/2010 <sup>73</sup>	Y <sup>74</sup>	N/A	These were senior notes, therefore an LPA was not executed
Scout Fund II - Hawkeye Partners	5/30/2012	Y	<b>9/24/2009</b>	N		
SRI Ten REIT – Shorenstein Realty Investors	10/15/2010	Y	10/14/2010	N		
WCP Real Estate Fund III(A) – Westport Capital Partners	12/16/2011	Y	12/14/2011	N		

<sup>73</sup> The form is dated July \_\_, 2010.

<sup>74</sup> DeAM Investor Services, Inc., an affiliate of the Investment Manager.

#### 4. Credit Strategies

D-4: Credit Strategies Fund Name	IMD Reported Closing Date	Was a form executed	Disclosure Letter Date On Form(s) Provided	Was a Placement Agent Used	Fee Structure	Placement Fee Terms
Anchorage Capital Partners	1/31/2011	Y	01/14/2011	N		
AG TALF Partners - Angelo Gordon	5/26/2009	Y <sup>75</sup>	11/19/2009 <sup>76</sup>	N		
AG GECC Public-Private Investment Fund - Angelo Gordon	2/19/2010	Y <sup>77</sup>	11/19/2009	N		
Brigade LCS Fund	2/28/2011	Y	01/07/2011	N		
CVI Credit Value Fund	6/29/2011	Y	06/24/2011	N		
Citadel Residential Mortgage Opportunities Fund	2/03/2011	Y	01/26/2011	N		
Claren Road Credit Fund	9/30/2011	Y	09/28/2011	N		
Fortress Credit Opportunities Fund III NS	3/19/2012	Y	3/19/2012	Y <sup>78</sup>	Placement agent is a Fortress entity and is compensated monthly at actual expenses + 1%; Certain employees of Fortress are entitled to bonus compensation based in part on the amount of capital raised	Placement agent fees paid by the General Partner or its Affiliates
GSO Capital Opportunities Fund II	11/17/2011	Y	10/20/2011	N		
Monarch Debt Recovery Fund	3/31/2011	Y	01/24/2011	N		
Oaktree Value Opportunities Fund	10/25/2011	Y	10/26/2011	Y <sup>79</sup>		Management fees reduced by placement fees paid by the partnership

<sup>75</sup> A form was executed, but separate forms were not executed for each of the investments.

<sup>76</sup> We were informed that this investment predates the placement agent policy.

<sup>77</sup> A form was executed, but separate forms were not executed for each of the investments.

<sup>78</sup> Fortress Capital Formation LLC.

<sup>79</sup> OCM Investments, LLC.

D-4: Credit Strategies Fund Name	IMD Reported Closing Date	Was a form executed	Disclosure Letter Date On Form(s) Provided	Was a Placement Agent Used	Fee Structure	Placement Fee Terms
PAAMCO-Newport Burgundy	12/29/2010	Y	11/15/2010	N		
Saba Capital Partners	8/31/2011	Y	08/22/2011	N		
Varde Fund X	6/29/2011	Y	06/15/2011	Y <sup>80</sup>	Up to 1.75% on capital raised	Management fees reduced by placement fees paid by the partnership
WLR IV PPIP Co-Invest – WL Ross & Company	3/2/2010	Y	<b>10/11/2009</b>	N		

<sup>80</sup> The Private Fund Advisory Group of Lazard Freres & Co. LLC and Lazard & Co, Limited.

## 5. Inflation Portfolio

D-5: Inflation Protection Fund Name	IMD Reported Closing Date	Was a form executed	Disclosure Letter Date On Form(s) Provided	Was a Place Agent Used	Fee Structure	Placement Fee Terms
ArcLight Energy Partners Fund V	10/14/2011	Y	9/1/2011, updated 12/16/2011	N		
Blackstone Resources Select	6/29/2011	Y	6/17/2011	N		
Credit Suisse Enhanced	5/31/2011	Y	4/19/2011	N		
Denham Commodity Partners Fund VI	2/28/2012	Y <sup>81</sup>	1/13/2012	Y	0.10%, 0.65% or 1.40% on capital raised	Management fees reduced by fees and out-of-pocket expenses of Park Hill Group LLC
EIF US Power Fund IV	10/25/2011	Y <sup>82</sup>	09/22/2011	Y	\$100,000 non-refundable retainer (credited against the placement fee);  0.50% on capital raised from existing investors up to \$900M;  1.75% on capital raised in excess of \$900M	Management fees reduced by placement fees paid by the partnership
EnCap Energy Capital Fund VIII	1/27/2011	Y <sup>83</sup>	01/19/2011	N		
EnCap Energy Capital Fund VIII Co-Invest	12/08/2011			N		
Energy Capital Partners II	8/16/2010	Y <sup>84</sup>	08/02/2010	Y	0.2464% on interests up to \$3.5B;  1.00% on interests from \$3.5B to \$4B;  0.75% on interests from \$4B to	Management fees reduced by placement fees paid by the partnership

<sup>81</sup> The Park Hill Group LLC.

<sup>82</sup> Atlantic-Pacific Capital, Inc.

<sup>83</sup> A form was executed, but separate forms were not executed for each of the investments.

<sup>84</sup> The Park Hill Group LLC.

					\$4.5B;  0.50% on interests sold over \$5B;  the Fund may award a discretionary bonus to the placement agent of up to \$1M	
Energy Capital Partners II (Summit Co-Invest)	10/20/2011	Y	<b>08/02/2010</b>	N		
Gresham TAP Flex	12/20/2010	Y	11/18/2010	N		
Perella Weinberg Partners ABV Opp Fund III	12/20/2011	Y	<b>No Date</b>	Y <sup>85</sup>		Placement agent fees are paid by the partnership in addition to the Management Fee. However, the manager has indicated that these fees have been minimal to date.
RK Mine Finance Fund II	03/29/2012	Y <sup>86</sup>	03/27/12	Y	\$25,000 monthly retainer (offset against incentive fees over \$3M); Incentive fee of 0.75%, 1.0% or 2.0% on capital raised; plus a reinvestment fee if the placement agent is not rehired for a subsequent fund	Management fees reduced by placement fees paid by the partnership
Sheridan Production Partners II	11/5/2010	Y	<b>10/26/2009</b>	N		
Vermillion Celadon	04/29/2011	Y	04/27/2011	N		

<sup>85</sup> Perella Weinberg Partners LP.

<sup>86</sup> Eaton Partners, LLC.

## **FINDINGS**

The Investment Checklist, prepared by external legal counsel, includes the execution of the placement agent disclosure letter as an item.

As the charts above reflect, disclosure letters were provided in advance of the closing date for most of the investments made during the Review Period. Where this was not the case, the investment is highlighted.

None of the global equity investments used a placement agent. A majority of the private equity investments and almost a third of the real estate, credit strategies, and inflation protection investments used a placement agent.

In some cases, the disclosure letter provided by the investment manager could not be matched to a specific investment because only one letter was provided even though there were multiple investments. Examples include BlackRock and the Energy Capital investments. For a few investments, the disclosure form provided was not executed proximate to the closing date, i.e., the disclosure letter was executed significantly, in some case several years, before the closing date.

## **CONCLUSIONS**

A disclosure letter should be provided for each investment, and the form letter should be modified to clearly specify the name of the investment for which it is being provided.

Agreements should not be presented to the Treasurer for execution without an acknowledgment that the disclosure letter has been provided. An acknowledgement by the General Counsel should be included as an item on the Treasurer's compliance checklist which would be included with each investment transaction prior to execution (See Tab 4).

## **RECOMMENDATIONS**

- Amend the placement agent form to include the name of the specific investment for which the form is being provided.
- Include an acknowledgment, on a compliance checklist to be provided to the Treasurer prior to execution of any investment agreement, that the required placement agent disclosure letter has been provided.
- Amend the placement agent policy to establish that the disclosure letter must be provided prior to the contract execution date.

## **B. FEE REVIEW**

HEK reviewed the fees of each of the investment managers in the Review Universe against industry averages/standards. We used an holistic approach in making our assessments regarding fees. We relied on our empirical experience supported by third party industry data. Manager fee information, particularly for alternative investments, is often considered to be proprietary. Therefore, the specifics of the fee provisions upon which our findings and conclusions were based are not included in this Report.

### **FINDINGS**

#### **1. Global Equity**

There were 16 global equity investments in the Review Universe.<sup>87</sup> When compared to the median universe fees, we found that the fees for all but one of the global equity investments were lower than the median. The exception was the Tiger Tar Heel Partners Fund with above-average early redemption fees at the equity long/short manager level, but below average to average fees otherwise.

#### **2. Private Equity**

There were 8 private equity investments in the Review Universe. We found all but one of the manager fees for private equity investments to be reasonable. The exception was Mount Kellet Capital Partners, which we found to have a relatively high management fee given the large size of the fund.

#### **3. Real Estate**

There were 17 real estate investments in the Review Universe. Overall, the fees for all of the real estate investments made during the Review Period were reasonable. We found elements of the fees for two investments to be slightly high: (1)

---

<sup>87</sup> Gladius was not reviewed because the manager refused to speak to HEK without a non-disclosure agreement (NDA).

Blackstone Real Estate Partners VII (the acquisition fee is not standard and there is an unfavorable catch-up provision, however the management fee was below market due to NC's large commitment), and (2) Hawkeye Partners/Scout Fund (the carried interest is slightly high).

#### **4. Credit Strategies**

There were 13 credit strategy investments that were reviewed.<sup>88</sup> Overall, we found the fees for the credit strategy investments to be reasonable. The redemption fees for two funds, Brigade LCS Fund and Saba Capital Partners, are slightly high, but the management fees for these funds are below average and the other fee elements are in line. Also, we found other expenses for Anchorage Partners to be slightly high when compared to the market but other fees for the fund were average.

#### **5. Inflation Protection**

There were 14 inflation protection investments in the Review Universe. The fees for the inflation protection investments were generally below average to reasonable. We found only one fund, Perella Weinberg ABV Opp. Fund III, with an above average hurdle rate.

### **CONCLUSIONS**

The IMD staff has done an excellent job of negotiating fees. Fees for many managers are below the industry average and overall no fee was unreasonable in the aggregate.

### **RECOMMENDATIONS**

None

---

<sup>88</sup> There were 15 in the Review Universe. However, two were dissolved.

## APPENDIX

**Tab 1 – The Review Universe consisted of investments made between January 2009 and June 30, 2012**

*The chart below is a reproduction of the document provided by IMD*

<u>Fund Name</u>	<u>Firm Name</u>	<u>Commitment</u>	<u>Closing Date</u>
<b>Global Equity</b>			
BlackRock Frontier Markets	BlackRock	\$150,000,000	4/1/2009
BlackRock Emerging Markets	BlackRock	\$200,000,000	6/1/2009
Mondrian Emerging Markets Equity	Mondrian Investment Partners	\$150,000,000	11/27/2009
MCM Large Cap Passive	Mellon Capital Management	\$1,824,000,000	4/1/2010
MCM Mid Cap Passive	Mellon Capital Management	\$610,000,000	4/1/2010
Wellington Mid Cap Opportunities	Wellington Management Company	\$795,000,000	4/9/2010
BlackRock ACWI ex US IMI	BlackRock	\$2,347,000,000	9/9/2010
Mondrian International Small Cap	Mondrian Investment Partners	\$250,000,000	9/9/2010
Franklin Templeton International Small Cap	Franklin Templeton	\$250,000,000	9/9/2010
Wellington Large Cap Value	Wellington Management Company	\$832,000,000	4/29/2011
RhumbLine Russell 200 Passive	RhumbLine Advisors	\$3,070,000,000	4/29/2011
BlackRock MSCI EAFE IMI	BlackRock	\$340,000,000	4/29/2011
BlackRock MSCI Canada	BlackRock	\$523,000,000	4/29/2011
BlackRock MSCI ACWI ex-US SC	BlackRock	\$643,000,000	4/29/2011
Gladius Aconcagua	Gladius Investment Group	\$1,000,000,000	9/26/2011 <sup>89</sup>
Tiger Tar Heel Partners	Tiger THP	\$140,000,000	4/18/2012
<b>Private Equity</b>			
Credit Suisse Innovation Fund	Credit Suisse	\$230,000,000	2/23/2010
Harvest Partners VI	Harvest Partners	\$100,000,000	9/28/2011
Vista Equity Partners Fund IV	Vista Equity Partners	\$50,000,000	10/28/2011
Tenaya Capital VI	Tenaya Capital Partners	\$75,000,000	11/15/2011

<sup>89</sup> Fund was not included in the fee review because the manager refused to speak with HEK without an NDA.

<b>Fund Name</b>	<b>Firm Name</b>	<b>Commitment</b>	<b>Closing Date</b>
Oaktree European Principal Fund III	Oaktree Capital Management	€ 35,617,600	12/7/2011
Mount Kellet Capital Partners II	Mount Kellet Capital Partners	\$75,000,000	2/15/2012
Accel-KKR Capital Partners IV	AKKR Management Company	\$10,000,000	3/16/2012
NEA 14	New Enterprise Associates	\$45,000,000	5/18/2012
<b>Real Estate</b>			
RREEF Global Opportunities Fund II, Senior Notes	RREEF	\$12,366,672	7/11/2010
AG Asia Realty Fund II	Angelo Gordon	\$25,000,000	7/30/2010
AG Net Lease Realty Fund II	Angelo Gordon	\$100,000,000	7/30/2010
SRI Ten REIT	Shorenstein Realty Investors	\$100,000,000	10/15/2010
CrossHarbor Institutional Partners II	CrossHarbor Capital Partners	\$150,000,000	12/23/2010
NorthCreek Fund	Rockwood Capital	\$205,000,000	1/31/2011
Patria Brazil Real Estate Fund II	Patria Brazil Real Estate Partners	\$50,000,000	3/31/2011
DRA Growth & Income Fund VII	DRA Advisors	\$150,000,000	5/9/2011
Lone Star Real Estate Partners II	Lone Star Real Estate Partners	\$300,000,000	5/26/2011
Harrison Street Real Estate Partners III	Harrison Street Real Estate Capital	\$60,000,000	6/6/2011
Blackstone Real Estate Partners VII	The Blackstone Group	\$300,000,000	8/15/2011
WCP Real Estate Fund III(A)	Westport Capital Partners	\$100,000,000	12/16/2011
Brookfield Real Estate Finance Fund III	Brookfield Real Estate Partners	\$100,000,000	12/30/2011
Scout Fund II	Hawkeye Partners	\$100,000,000	5/30/2012
Northrock Fund II	Rockwood Capital	\$400,000,000	6/15/2012
Rockwood Capital Fund IX	Rockwood Capital	\$50,000,000	6/15/2012
Rockpoint Real Estate Fund IV	Rockpoint Group	\$100,000,000	6/18/2012
<b>Credit Strategies</b>			
AG TALF Partners	Angelo Gordon	\$73,214,286	5/26/2009 <sup>90</sup>
AG GECC Public-Private Investment Fund	Angelo Gordon	\$200,000,000	2/19/2010
WLR IV PPIP Co-Invest	WL Ross & Company	\$150,000,000	3/2/2010
PAAMCO-Newport Burgundy	PAAMCO	\$500,000,000	12/29/2010
Anchorage Capital Partners	Anchorage Capital Partners	\$300,000,000	1/31/2011

<sup>90</sup> Fund was not included in the fee review because it was dissolved.

<b>Fund Name</b>	<b>Firm Name</b>	<b>Commitment</b>	<b>Closing Date</b>
Citadel Residential Mortgage Opportunities Fund	Citadel	\$119,072,245	2/3/2011 <sup>91</sup>
Brigade LCS Fund	Brigade Capital Management	\$300,000,000	2/28/2011
Monarch Debt Recovery Fund	Monarch Alternative Capital	\$300,000,000	3/31/2011
CVI Credit Value Fund	CarVal Investors	\$150,000,000	6/29/2011
Varde Fund X	Varde Partners	\$100,000,000	6/29/2011
Saba Capital Partners	Saba Capital Partners	\$100,000,000	8/31/2011
Claren Road Credit Fund	Claren Road Asset Management	\$100,000,000	9/30/2011
Oaktree Value Opportunities Fund	Oaktree Capital Management	\$150,000,000	10/25/2011
GSO Capital Opportunities Fund II	GSO Capital Partners	\$100,000,000	11/17/2011
Fortress Credit Opportunities Fund III	Fortress Investment Group	\$75,000,000	3/19/2012
<b>Inflation Protection</b>			
Energy Capital Partners II	Energy Capital Partners	\$50,000,000	8/16/2010
Sheridan Production Partners II	Sheridan Production Partners	\$165,000,000	11/5/2010
Gresham TAP Flex	Gresham Investment Management	\$800,000,000	12/20/2010
EnCap Energy Capital Fund VIII	EnCap Investments	\$50,000,000	1/27/2011
Vermillion Celadon	Vermillion	\$300,000,000	4/29/2011
Credit Suisse Enhanced	Credit Suisse Group	\$500,000,000	5/31/2011
Blackstone Resources Select	Blackstone Alternative Asset Management	\$500,000,000	6/29/2011
ArcLight Energy Partners Fund V	ArcLight Capital Holdings	\$100,000,000	10/14/2011
Energy Capital Partners II (Summit Co-Invest)	Energy Capital Partners	\$20,000,000	10/20/2011
EIF US Power Fund IV	EIF Management	\$75,000,000	10/25/2011
EnCap Energy Capital Fund VIII Co-Invest	EnCap Investments	\$12,148,000	12/8/2011
Perella Weinburg Partners ABV Opp Fund III	Perella Weinburg Partners	\$150,000,000	12/20/2011
Denham Commodity Partners Fund VI	Denham Capital	\$75,000,000	2/28/2012
RK Mine Finance Fund II	Red Kite General Partner Limited	\$75,000,000	3/29/2012

<sup>91</sup> Fund was not included in the fee review because it was dissolved.

(This page left blank intentionally)

## **Tab 2 – Interviewees**

Hewitt EnnisKnupp interviewed the following individuals:

### **NCDST**

- Janet Cowell, Treasurer
- Jay Chaudhuri, General Counsel & Senior Policy Advisor
- Blake Thomas, Assistant General Counsel

### **IMD**

- Bryan Lewis, CAO & Interim CIO
- Michael Ruetz, Director of Risk Management
- Susan Carter, Director of Real Estate
- Jeff Smith, Director of Fixed Income
- Craig Demko, Director of Alternatives

### **OUTSIDE COUNSEL**

- Kenneth Shelton, Womble Carlyle Sandridge & Rice

### **FORMER EMPLOYEES OF IMD**

- Shawn Wischmeier, Former CIO
- Rodney Overcash, Former Director of Credit and Inflation

**FORMER ASSISTANT GENERAL COUNSEL**

- Kara L. Petteway

### Tab 3 – Documents Requested and Reviewed

To gather relevant information for the review, Hewitt EnnisKnupp obtained and reviewed the following documents. Some documents were provided by IMD and others were obtained by the NCDST website or the Womble Carlyle extranet site.

- The list of investments that comprised the Review Universe
- Select laws and statutes:
  - G.S. 147-69.1 – Investments authorized for general fund and highway fund assets
  - G.S. 147-69.2 – Investments authorized by special funds held by the State Treasurer
  - G.S. 147-69.3 – Administration of State Treasurer’s investment programs
  - G.S.114-8.3 – Attorney General to review certain contracts.
- The Investment Policy Statement for North Carolina Retirement Systems (February 2012 draft and November 2012 approved)
- North Carolina Department of State Treasurer Signatory Authority Policy (11/22/11 reversion provided)
- The Equity Investment Process Description
- Comprehensive Annual Financial Reports (CAFR) for 2009-2010 and 2010-2011
- Organizational charts
  - Office of State Treasurer
  - Investment Management Division
- Due Diligence Reports for Global Equity, Private Equity, Real Estate, Credit Strategies, Inflation Portfolio

- Investment Recommendation Memorandums for Global Equity, Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Summary Memorandums for Global Equity, Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Final Checklists for Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Limited Partnership Agreements for Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Amended Partnership Agreements for Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Subscription Agreements for Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Guaranty Agreements for Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Side Letters for Private Equity, Real Estate, Credit Strategies, Inflation Portfolio
- Womble Carlyle Sandridge & Rice Extranet Site containing IMD documents

**Tab 4 – Sample Cover Compliance Sheet for the State Treasurer**

Date \_\_\_\_\_

1) Name of Investment \_\_\_\_\_

2) Type of Investment \_\_\_\_\_

3) Recommended Allocation \$\_\_\_\_\_ timing\_\_\_\_\_ and source of funding\_\_\_\_\_

4) Compliance with statute\_\_\_\_\_

Signature of Compliance Officer and/or Legal Counsel

5) Compliance with all provisions of the Investment Policy Statement\_\_\_\_\_

Signature of Chief Investment Officer

6) Compliance with current asset allocation \_\_\_\_\_

Signature of Chief Investment Officer

Signature of Director

7) Compliance with due diligence checklist\_\_\_\_\_

Signature of Director

Signature of Consultant

8) Placement Agent Disclosure has been provided \_\_\_\_\_

Signature of General Counsel

9) Legal review of contract completed\_\_\_\_\_

Signature of General Counsel

**Investment approved by State Treasurer**

Janet Cowell

Date

Transfer

Receipt

Audit of Fund Transfer

(This page left blank intentionally)

## Tab 5 – Listing of All Recommendations

Below is a complete list of the recommendations that are included in the Report.

	Recommendations	Page #
<b>Decision-Making Process and Compliance</b>		
1.	Seek a statutory amendment to restore the Treasurer’s independent contracting authority.	12
2.	Develop a systematic process to regularly monitor and report on policy compliance to the Treasurer.	19
3.	Clarify the application of the No Contact policy.	19
4.	Conduct in-house training and periodic testing to ensure that the IMD and investment operations and accounting staff are familiar with applicable investment policies and practices.	19
5.	Adopt a charter for the internal investment committee that defines its purpose, authority, and composition.	24
6.	Enhance and consolidate the written documentation describing the investment decision-making process for each asset class.	24
7.	Develop a document that defines the required steps in the investment decision-making process for each asset class, including the specific documents that must be produced to verify the rationale for investing.	29
8.	Develop a charter for the internal investment committee.	29
9.	For each asset class, create a standardized due diligence/investment recommendation memo template, including the minimum content each report should address.	29
10.	Develop a compliance checklist cover sheet to accompany each investment that is presented to the Treasurer.	29
11.	Consider using the asset class investment consultants to better complement and supplement IMD’s investment resources.	29
12.	Engage internal legal counsel more in the investment decision-making coordination and documentation process.	29
13.	Provide the summary memo prior to the closing date for an investment.	29

	<b>Recommendations</b>	<b>Page #</b>
14.	Establish a centralized log and filing system for investment due diligence and participant documents.	29
15.	Establish a process to ensure that, prior to funding, the basis for each investment decision is documented in compliance with the requirement of the IPS (Related to Recommendation 10)	37
16.	Include a section in the due diligence memo, the recommendation memo, and the checklist that specifically acknowledges that the investment is in compliance with statutory requirements, the IPS, and other applicable policies that have been approved by the Treasurer or established by the IMD CIO.	37
17.	Improve the investment decision documentation for global equity investments, including: (1) ensuring that a recommendation memo is prepared; and, (2) using a checklist and/or summary memo comparable to the documentation used for other asset classes.	37
<b>Review of Placement Agent Usage and Investment Manager Fees</b>		
Placement Agent Review		
18.	Amend the placement agent form to include the name of the specific investment for which the form is being provided.	50
19.	Include an acknowledgment, on a compliance checklist to be provided to the Treasurer prior to execution of any investment agreement, that the required placement agent disclosure letter has been provided.	50
20.	Amend the placement agent policy to establish that the disclosure letter must be provided prior to the contract execution date.	50
Fee review		
No Recommendations		