

**Teacher Retirement System
of Texas**



1000 Red River Street
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EXECUTIVE DIRECTOR
Ronnie G. Jung

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August 27, 2009

Ms. Pam Munn
Special Investigations Unit
State Auditor's Office
Robert E. Johnson Building
1501 North Congress Avenue, Suite 4.224
Austin, Texas 78701

Re: Teacher Retirement System of Texas Report on Staff Allegations

Dear Ms. Cantu:

In April of this year, allegations by Teacher Retirement System of Texas (TRS) staff were brought to my attention. Upon learning of the allegations, I authorized outside counsel to examine the allegations. The allegations are summarized in the attached report prepared by outside counsel, which is being provided to you in accordance with reporting guidelines.

At the end of the report, outside counsel has made recommendations. I support the recommendations and will be working with the Chief Investment Officer, fiduciary counsel, and others to implement them in a satisfactory manner. At its August meeting, the TRS Board adopted a revised Governance and Ethics Policy, which addresses areas of concern raised by TRS staff, and training will be conducted, including training by fiduciary counsel.

Please feel free to contact me if you have further questions or need additional information.

Sincerely,

A handwritten signature in black ink that reads "Ronnie Jung".

Ronnie Jung

cc: Amy Barrett, Chief Audit Executive, TRS

MEMORANDUM

TO: Mr. Ronnie Jung, Executive Director, TRS
FROM: Roel C. Campos *rc*
DATE: August 25, 2009
RE: Investigation of Employee Complaints

REPORT

This memorandum is in response to a request from TRS Executive Director Ronnie Jung to investigate and report on allegations made by certain TRS employees involving members of the TRS Board of Trustees and, to some extent, the Chief Investment Officer ("CIO"). Because TRS supports the policy and the applicable laws that protect employees and encourage them to bring forth valid complaints, this memo does not reveal employee identities.

I. Employees' Allegations Involving the Trustees and the CIO

In April 2009, a TRS employee contacted the Executive Director and lodged several complaints alleging improper influence on investment decisions and improper use of TRS data. Later that month, a second TRS employee independently approached the Legal Services staff to complain about perceived flaws in investment procedures. The allegations raised concerns that:

- A. Certain Trustees had appeared to them to be improperly interfering with and attempting to influence investment decisions as to fund managers selected by Staff, contrary to the Board's delegation of this responsibility to the Staff;
- B. Certain Trustees or others may be improperly influencing the CIO, who, in turn, was intimidating Staff to curry favor with the Trustees and others;
- C. The environment in which the investment selection process takes place does not always encourage meaningful expressions of opinion, resulting in concerns that some decisions may lack accountability or are sub-optimal decisions for TRS beneficiaries; and
- D. A Trustee and employees of the Trustee's own commercial business (the "Company") requested and received from TRS: (1) summaries of banking private

equity transactions for past years from a TRS-purchased subscription service and (2) pitch books submitted by outside fund managers for investment consideration for personal gain and for the benefit of the Company.

II. Investigation of Employee Allegations

Upon learning of these allegations—and to consider them accordingly—the Executive Director and General Counsel decided that a thorough internal investigation was necessary. Close attention was given to these accusations because, if true, the charges could undermine the trust of the beneficiaries and the public in the workings of TRS.

Accordingly, TRS retained former SEC Commissioner Roel Campos of this firm, Cooley Godward Kronish LLP to conduct an investigation of the allegations. Commissioner Campos involved several other lawyers from his firm and provided other resources required to conduct the investigation expeditiously. The General Counsel and her colleagues were integral parts of the team. An extensive investigation was conducted, reviewing over 1200 pages of emails and many other documents, policies, and statutes. With the assistance of the General Counsel and her colleagues, Commissioner Campos personally interviewed thirteen individuals, travelling as required, and interviewed and reviewed documents in the possession of the Trustee and his business colleagues.

III. Summary of Findings of Investigation

After completing a thorough investigation of each allegation, including researching and studying applicable law and analyzing the evidence, the investigation revealed the issues discussed below. The first three overlapping and related issues stemmed, for the most part, from a small set of investments considered primarily by the Private Markets Group. The fourth issue arises from a separate set of facts.

- A. **Improper influence of Staff.** TRS employees identified several investments for which they had concerns that individual Trustees influenced the final decision. In several of the matters, Trustees referred a fund manager for consideration or were otherwise interested in the Staff's decision. Trustees therefore periodically asked senior Staff about the status of the investment decision. The discussions among Trustees and senior Staff, including the CIO, with regard to these relatively few transactions seemed to occur in an unstructured way, creating suspicion among some Staff members that Trustees were directing that certain fund managers be selected. After conducting the thirteen interviews, reviewing documentation, including preliminary investment memoranda ("PIMs") and due diligence memoranda (DDMs), and using the tools available to this investigation, the investigation uncovered no definitive evidence that any Trustee improperly influenced any investment decision.

- B. Improper influence of, and intimidation by, the CIO. Staff also identified instances of discussions between the CIO and Trustees regarding certain investments. Several employees described the CIO as placing great importance on “getting along” with Trustees—perhaps, they surmised, to get Trustee support for the CIO’s vision for TRS’s investment program and division. Employees described instances of the CIO putting heavy pressure on Staff to change an initial recommendation in contradiction to the Staff member’s own views. They were concerned that the CIO may have been placing such pressure for the purpose of pleasing interested Trustees. Several individuals interviewed stated that the CIO seemed unduly biased toward working with well-known managers in the industry and had a strong preference to do business with them. At least one Staff member felt that, in order to create the appearance of unanimity, the Staff member was pressured to endorse an investment recommendation that was the CIO’s decision—a decision with which the Staff member did not agree, based upon the criteria that the Staff member believed should be applied. The Staff expressed an uncertainty in how they were to handle Trustee-referred investments and believed they were instructed to handle such investment decisions outside the normal process. Staff felt that some investments seemed to be given special handling and were “resurrected” or focused on as a result of individual Trustee inquiries.

In his interview, the CIO provided reasonable explanations for the investment decisions questioned by TRS employees. In many instances, for example, the CIO explained his decisions by pointing out that, as the senior investment officer, it was his ultimate decision, and that he had experience and knowledge of the investment world that subordinates did not. Accordingly, he was entitled and obligated to overrule subordinates when they had misunderstood the importance of various aspects of investments and their fit within the portfolio that he could assess in a better and more sophisticated manner. Documentation regarding these investments and interviews show nothing to indicate Trustee influence or involvement in the ultimate decisions, although some evidence suggested Trustee involvement or interest in the initial or intermediate phases of due diligence. There was no definitive evidence of specific requests by Trustees to make particular investments or of Trustee bias toward particular managers. The CIO explained his belief that it is human nature to give a matter attention when your boss inquires about it and that he (as CIO) was learning the facts and the status of the investment opportunity and reviewing it to make sure he and his Staff could support the action taken on the matter.

In sum, the investigation uncovered no definitive evidence that any Trustee improperly influenced the CIO with respect to any TRS investment decision.

- C. Expression of differences of opinion and management communication issues. Staff expressed their concern with what they characterized as an investments

selection process in the Private Markets Group that, at certain critical points, did not allow for every involved Staff member to meaningfully express differences of opinion. For a limited number of investment decisions, some Staff members believed that the CIO was pressuring them to reach conclusions that were contrary to their evaluation of the investment. Further, in those instances Staff objected to the fact that the CIO's action was not documented in the investment recommendation. (This sentiment often combined with a concern by the involved Staff that Trustee influence must have driven the CIO's involvement.) In almost all cases, however, the due diligence process appeared to be robust, adequately documented, and structured in a manner that facilitated the objective evaluation of potential investments. The CIO explained his reasons for intervening in the due diligence process from time to time, based upon his greater knowledge, experience, and understanding of the needs of TRS. The CIO also explained that he sometimes requires Staff to conduct further due diligence if they miss considerations or information that he deems important.

The investigation found that communications between the CIO and Staff members in the Private Markets Group generally could be improved. The CIO's authoritative management style appears to have contributed significantly to an environment of high anxiety for several employees who expressed either a reticence in openly opposing the CIO after expressing their point of view or the need to exercise caution in their interactions with the CIO. Notwithstanding any actual or perceived shortcomings of the due diligence process, the final decision to invest in a particular transaction must be approved by the Internal Investment Committee ("IIC"), and that process appeared to provide a rigorous review and open discussion of a potential transaction by numerous senior investment Staff, including the CIO. In addition, minutes of each meeting are kept. Further, based on the form of documentation that we observed, it is possible for an investment opportunity to come before the IIC even where there is a recommendation to decline; however, in practice, it is our understanding that such a circumstance has occurred only once and the members of the IIC were surprised that they were being asked to review it. Nevertheless, in some instances during the due diligence phase, some Staff seemed to feel pressure to "see it the CIO's way" and make a recommendation for a transaction to proceed to the IIC for review. Some Staff would prefer a mechanism that allows them to move a potential investment to the next phase in the selection process, along with the due diligence materials and perhaps a prudence opinion, without having to personally recommend that the investment be approved by the IIC, if a difference of opinion over criteria or weighting persists.

We note that the Private Markets Group, along with the entire Investment Division, has undergone significant changes over the last two and half years and the leadership and processes for decision making regarding these private

investments have and are evolving, such that the Executive Director may choose to assess this further or from time to time as deemed prudent.

In sum, the investigation disclosed credible evidence that (1) the IIC – the final phase of the investment selection process – did allow for a robust discussion and evaluation of investment recommendations, but that (2) communications between the Staff and the CIO, particularly but not only during the due diligence phase, could be improved to reduce unproductive friction and stress and to create an environment that, in practice, fosters relevant debate and maintains a professional fiduciary process for evaluating investment opportunities.

- D. Use of TRS information and materials by a Trustee.¹ The issue involved in this part of the investigation is the access to, and use by, Trustees of TRS information, data, and private placement memoranda and pitch books from external managers submitted for investment consideration. Trustees quite properly have the right to access all such information and materials for TRS purposes, including educating themselves to better discharge their oversight duties. However, if information or materials are requested or used for a personal or commercial use (not a TRS purpose), violations of ethical policies may occur.

1. *TRS information.* In November of 2007, a Trustee received an email from one of his business colleagues, asking the Trustee for help in obtaining information and asking the Trustee whether he had access to a particular subscription database² to obtain private equity information. The Trustee forwarded the email to a TRS employee and asked whether the TRS employee could assist his colleague. At that point in time, TRS was starting a paid subscription to the database. After a series of email communications, a TRS employee compiled from the subscription database summary tables describing private equity deals by sector from 1995 to 2007 and sent the information to the Trustee. This information from TRS was ultimately used as background discussion in the Trustee's Company commercial pitch books and private placement memoranda, in the form of pie charts - showing the proportion of financial sector private equity transactions. After initially requesting TRS's assistance and

¹ The Trustee has been fully briefed about the findings of this investigation and has been allowed to review the memorandum summarizing his interview. The Trustee has also been provided an opportunity to prepare a statement or communication to the Executive Director and the Trustees.

² The subscription database company at issue is a proprietary data compilation service to which TRS became a subscriber in November 2007. The contract between TRS and the company specified that TRS was "granted permission to create and use Derivative Materials for internal use and for external publication in the normal course of [TRS's] business..."

forwarding the data he received to his colleague, the Trustee maintains that he did not track or monitor whether the use of the information obtained from TRS was used solely for TRS purposes.

Apart from forwarding the requests for the data from his business colleagues to TRS and forwarding the data received to his colleague, the Trustee maintains that he was not involved in preparing his Company's pitch books or in deciding to insert the pie charts that contained the TRS information. The Trustee maintains that, in making the requests for TRS assistance, he sought only to aid his colleague and that he had no intention that TRS information be used for a commercial purpose. The Trustee stated that he was surprised when he learned that the data that TRS provided was used in his Company's pitch books and private placement memoranda. The Trustee maintains that the commercial use of the TRS data in the pitch books and private placement memoranda was inadvertent and, essentially, a mistake.

The Trustee's fund company did not appear to – and it is reasonable to conclude that it did not – make a profit or obtain new investors as a result of using the TRS information in the company's pitch books and private placement memoranda. TRS employee time was involved in gathering the information, and TRS also incurred the fixed cost of the database subscription, a cost it would have incurred regardless of the Trustee's conduct. Other than those two costs, which were fixed, there appear to be no other direct costs resulting from this incident to date

Given the facts presented, the Trustee may have violated Section III.J of the Trustee Ethics Policy, which states, in relevant part: "No Trustee . . . may use TRS information, resources, or facilities, nor may they use information or resources paid for by TRS, for personal gain . . ."³ However, there is also evidence to support that the commercial use of TRS information in the pitch books and private placement memoranda was inadvertent.

³ Based on the same evidence, and for the same reasons, the Trustee could also have violated Section I.D of the Trustee Ethics Policy, which states that "Trustees and Employees may not use their relationship with TRS to seek or obtain personal gain beyond agreed compensation and/or any properly authorized expense reimbursement."

Given the facts herein, it does not follow that there is necessarily an actionable breach of fiduciary duty. Without actual harm to the trust, there would be no damages to sustain a claim of breach.⁴

- a. In summary, the Trustee provided the following explanations and defenses for the occurrence: (a) as described above, he never intended to obtain TRS information for personal gain or to have the information used in the commercial pitch books – it was essentially a mistake that this occurred; (b) if one of the TRS employees had told him that there was a problem with TRS providing the information, he would have obtained the information from a different source, as many brokers with whom he has a business relationship would have provided the same information; (c) the TRS practices that had existed from the time that the Trustee became a Trustee allowed for a free exchange of information between Staff and Trustees; (d) the information collected was also for TRS' benefit, as it provided the Trustee, as a TRS Trustee, and TRS important educational material that the Trustee would find useful in his role as Trustee; (e) the Trustee may have requested the data as a result of questions that arose during a Board of Trustees meeting in 2007; (f) the Trustee over the years of service to TRS has provided significant and valuable advice to the Staff that has led to better investment decisions and that give-and-take environment led to his belief that he was allowed to obtain the information; (g) the information is immaterial and did not, on its own, within the pitch books touting the Trustee's Company, cause anyone to decide to invest with the Company; and (h) the information provided the Trustee a negligible personal gain and no business profit.
- b. Separately, the investigation also encountered many examples of a high level of service from the Trustee to TRS, in which he generously provided his time and expertise to the Staff. The General Counsel also noted that the Trustee had been diligent over the years in efforts to avoid conflicts of interest before they arose. Further, the Trustee fully cooperated in this investigation.

2. *Private Placement Memoranda.* The Trustee also requested various private placement memoranda from TRS for the apparent purpose of educating himself on how performance data was used by other external

⁴ The database company will be contacted to verify that it will not object to the inadvertent use of their database. They were credited for the pie charts and presumably would be more interested in maintaining the ongoing relationship with TRS.

managers and displayed in their own private placement memoranda - so that he could test and evaluate his own performance data display in his company's private placement memoranda. The Trustee justified the request by stating that he was allowed to use such data since it would contribute to his being a better Trustee. The Trustee explained that he never made any changes to his own private placement memoranda as a result of this request—in part because his compliance officer would not allow him to.

- a. However, the private placement memoranda provided to TRS by external managers are treated as confidential and may be disclosed *only* for purposes related to TRS business. As a result, any private placement memoranda submitted to TRS and received by the Trustee could *only* be used in his capacity as Trustee and not for aiding the performance display in his own commercial materials.
- b. The Trustee statement that he wanted to assess his Company's presentation against these materials could be viewed as an admission, thus presenting evidence that he sought the memoranda for a non-TRS purpose. Under these facts, the Trustee could be viewed as violating the confidentiality of the documents and violating Section III.J of the Ethics Policy. However, the Trustee made no use of the material in the memoranda (no changes in his fund's promotional materials), nor did he distribute the memoranda to other employees, all of which are facts arguably supporting no violation of confidentiality and no violation of III.J.

IV. Recommendations

In light of the findings of this investigation, the recommendations below have been made to Mr. Jung. It is noted that TRS has started the process of implementing these recommendations. In particular, at its August Board meeting, the Board adopted a revised Trustee Governance and Ethics Policy, which addresses areas of concern raised by TRS staff.

- A. The Executive Director should recommend that the Board discuss the roles of the Board and individual Trustees, discuss and consider adopting a new set of ethics and governance policies, and specifically consider a new portion of the policies that would provide guidelines for the interaction between Trustees and between Trustees and the Staff, including the handling of referrals, inquiries and requests for information from individual Trustees as well as monitoring responsibilities and disclosures.
- B. TRS should organize and conduct training for all Staff and Trustees to ensure that procedures and new policies established are understood and implemented

effectively. This training should thereafter be incorporated into the annual training sessions of both Trustees and Staff.

- C. The Executive Director and the CIO should work together to improve communications between the Staff and the CIO, particularly but not only during the due diligence phase of the investment selection process, to reduce unproductive friction and stress, to consider procedures that memorialize professional disagreements in evaluating external managers and investments, and to create an environment that, in practice, fosters relevant debate and maintains a professional fiduciary process for evaluating investment opportunities.