

FILED

COMMONWEALTH OF KENTUCKY  
COUNTY OF FRANKLIN CIRCUIT COURT  
CASE NO. CI-17-1348

DIVISION 1

JEFFREY C. MAYBERRY, HON. BRANDY O. BROWN,  
MARTHA ANN MILLER, STEVE ROBERTS, TERESA  
STEWART, JASON LAINHART, DON D. COOMER, and  
BEN WYMAN, Derivatively as Members and  
Beneficiaries of Trust Funds on behalf of the  
KENTUCKY RETIREMENT SYSTEMS, and as  
Taxpayers on behalf of the Commonwealth of Kentucky,

**PLAINTIFFS**

v. **VERIFIED COMPLAINT BY MEMBERS OF THE  
KENTUCKY RETIREMENT SYSTEMS PLEADING A  
MEMBER/BENEFICIARY DERIVATIVE ACTION FOR  
THE KENTUCKY RETIREMENT SYSTEMS  
AND ITS TRUST FUNDS  
and  
A TAXPAYER ACTION ON BEHALF OF THE  
COMMONWEALTH OF KENTUCKY**

**DEFENDANTS**

KKR & CO., L.P.

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

KKR & CO., L.P  
c/o The Corporation Trust Company  
Corporation Trust Center  
1209 Orange Street  
Wilmington, DE 19801

HENRY KRAVIS

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Henry R. Kravis, Co-Chairman and Co-CEO, KKR  
9 West 57th Street, Suite 4200  
New York, NY 10019

GEORGE ROBERTS

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

George R. Roberts, Co-Chairman and Co-CEO, KKR  
2800 Sand Hill Road  
Suite 200  
Menlo Park, California 94025

PRISMA CAPITAL PARTNERS, L.P.

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Prisma Capital Partners LLC  
c/o The Corporation Trust Company  
Corporation Trust Center  
1209 Orange Street  
Wilmington, DE 19801

GIRISH REDDY

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Girish Reddy, Co-CEO PAAMCO Prisma  
9 West 57th Street  
26th Floor  
New York, NY 10019

BLACKSTONE GROUP, L.P.

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Blackstone Group, L.P.  
c/o The Corporation Trust Company  
Corporation Trust Center  
1209 Orange Street  
Wilmington, DE 19801

STEVEN A. SCHWARZMAN

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Stephen A. Schwarzman, Chairman, CEO, and Co-  
Founder  
Blackstone Group, L.P.  
345 Park Avenue  
New York, NY 10154

J. TOMILSON HILL

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))

MAIL TO:

J. Tomilson Hill, Vice Chairman  
Blackstone Group, L.P.  
345 Park Avenue  
New York, NY 10154

PACIFIC ALTERNATIVE ASSET MANAGEMENT  
COMPANY, LLC

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))

MAIL TO:

PAAMCO PRISMA HOLDINGS, LLC  
c/o Corporation Service Company  
251 Little Falls Drive  
Wilmington, DE 19808

JANE BUCHAN

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))

MAIL TO:

Jane Buchan, CEO, PAAMCO  
19540 Jamboree Road, Suite 400  
Irvine, CA 92612

GOVERNMENT FINANCE OFFICERS ASSOCIATION

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))

MAIL TO:

Jeffrey L. Esser  
203 North LaSalle Street, Suite 2700  
Chicago, IL 60601

CAVANAUGH MACDONALD CONSULTING, LLC

SERVE: By certified mail pursuant to CR 4.01

National Corporate Research, LTD.  
828 Lane Allen Road, Suite 219  
Lexington, Kentucky 40504

THOMAS CAVANAUGH

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO BOTH ADDRESSES:

Thomas Cavanaugh  
32 Flagship Lane,  
Hilton Head, SC 29926

Thomas Cavanaugh, Co-Founder  
Cavanaugh Macdonald Consulting, LLC  
3550 Busbee Parkway, Suite 250  
Kennesaw, GA 30144

TODD GREEN

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Todd Green, Principal  
Cavanaugh Macdonald Consulting, LLC  
3550 Busbee Parkway, Suite 250  
Kennesaw, GA 30144

ALISA BENNETT

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Alisa Bennett, Principal  
Cavanaugh Macdonald Consulting, LLC  
3550 Busbee Parkway, Suite 250  
Kennesaw, GA 30144

ICE MILLER, LLP

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Phillip R. Scaletta  
One American Square,  
Suite 3100  
Indianapolis, Indiana 46282

R.V. KUHNS & ASSOCIATES, INC. (also d/b/a RVK, Inc.)

SERVE: By certified mail pursuant to CR 4.01

CT Corporation System  
306 W. Main Street, Suite 512  
Frankfort, Kentucky 40601

JIM VOYTKO

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Jim Voytko  
c/o RVK, Inc.  
211 SW 5th Avenue, Suite 900  
Portland, Oregon 97204

REBECCA A. GRATSINGER

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

Rebecca A. Gratsinger, CEO  
c/o RVK, Inc.  
211 SW 5th Avenue, Suite 900  
Portland, Oregon 97204

WILLIAM COOK

SERVE: By certified mail pursuant to CR 4.01

William Cook  
1400 Willow Ave Apt 1804  
Louisville, KY 40204

RANDY OVERSTREET

SERVE: By certified mail pursuant to CR 4.01

Randy Overstreet  
115 Fox Ridge Road  
Bardstown, KY 40004

TIMOTHY LONGMEYER

SERVE: By certified mail pursuant to CR 4.01

Timothy Longmeyer, Register # 20844-032  
FPC Montgomery  
Federal Prison Camp  
Maxwell Air Force Base  
Montgomery, AL 36112

BOBBIE D. HENSON

SERVE: By certified mail pursuant to CR 4.01

Bobbie Henson  
366 Valley Road  
Frankfort, KY 40601

THOMAS ELLIOTT

SERVE: By certified mail pursuant to CR 4.01

Thomas Elliott, Senior Vice President  
Old National Bank  
333 E Main St Suite 100  
Louisville, Kentucky 40202

JENNIFER ELLIOTT

SERVE: By certified mail pursuant to CR 4.01

Jennifer Elliott  
9409 Delphinium Street # 101  
Prospect, KY 40059

VINCE LANG

SERVE: By certified mail pursuant to CR 4.01

Vince Lang  
Kentucky County Judge/Executive Association  
115 East Second Street  
Frankfort, Kentucky 40601

DAVID PEDEN

SERVE: By certified mail pursuant to CR 4.01

David Peden,  
Mercer, Senior Investment Consultant  
701 Market Street, Suite 1100  
St. Louis, Missouri 63101

T.J. CARLSON

SERVE: KENTUCKY SECRETARY OF STATE (454.210(3)(c))  
MAIL TO:

T. J. Carlson  
c/o Texas Municipal Retirement System  
P.O. Box 149153  
Austin, Texas 78714-9153

BRENT ALDRIDGE

SERVE: By certified mail pursuant to CR 4.01

Brent Aldridge  
1045 Forrest Hill Drive  
Lawrenceburg, KY 40342

WILLIAM A. THIELEN

SERVE: By certified mail pursuant to CR 4.01

William A. Thielen  
3129 Blenheim Way  
Lexington, Kentucky 40503-5469

and

KENTUCKY RETIREMENT SYSTEMS

SERVE: By certified mail pursuant to CR 4.01

Hon. Andrew Graham Beshear  
Attorney General of the Commonwealth of Kentucky  
700 Capital Avenue, Suite 118  
Frankfort, KY 40601-3449

**NOMINAL  
DEFENDANT**

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***“[T]he trillions of dollars held in pension plans are an enticing target for intermediaries and service providers who are opportunistic, desperate or just plain greedy”***

Dana M. Muir, “DECENTRALIZED ENFORCEMENT TO COMBAT FINANCIAL WRONGDOING IN PENSIONS; WHAT TYPE OF WATCHDOGS ARE NECESSARY TO KEEP THE FOXES OUT OF THE HENHOUSES,” 53 Am. Bus. L.J. 33, 34 (2016).

## **I. OVERVIEW OF ALLEGATIONS**

1. Members and beneficiaries of the Kentucky Employees Retirement Systems (“KRS”), on behalf of KRS, and as taxpayers on behalf of the Commonwealth of Kentucky,<sup>1</sup> bring this derivative<sup>2</sup> action, seeking compensatory and punitive damages and equitable and injunctive relief. The relief sought includes (i) damages for the losses incurred by KRS as a result of breaches of fiduciary and other duties, including unsuitable investments, the loss of trust assets, the loss of prudent investment opportunities and positive investment returns; (ii) disgorgement of fees from the sellers of unsuitable hedge fund products, investment, actuarial and fiduciary advisors and the annual report certifier; and (iii) the greatly increased costs to the taxpayers of restoring KRS and its Pension Plans to properly funded status, after years of concealment of the true financial condition of KRS and the waste of its

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<sup>1</sup> All allegations herein regarding the “taxpayers” of Kentucky is a reference to the entire Commonwealth and its treasury, and not to individual taxpayers or any recovery by those individuals or by Plaintiffs.

<sup>2</sup> A derivate action is an equitable action giving the court its full powers of equity in a proceeding providing plaintiffs with a jury trial. “Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations,” Thomas E. Rutledge, 103 Ky. L.J. Online 4 (2015); “Public Pension and Fiduciary Law: A View From Equity,” T. Leigh Anenson 50 Univ. of Michigan Journal of Law Reform 251 (2016).

funds. The action alleges Defendants' individual breaches of duty, their participation in a joint enterprise and their knowing aiding and abetting of one another while participating in a scheme, civil conspiracy, and concerted course of conduct in violation of Kentucky law. Because of the wanton nature of the misconduct of certain defendants, punitive damages are sought from them.

2. Defendants are (i) the Hedge Fund Sellers (defined below) who created and sold unsuitable, high-risk, high-fee funds of hedge funds to KRS; (ii) KRS' investment, actuarial and fiduciary advisors; (iii) the KRS annual report certifier; and (iv) certain KRS Trustees and Officers who oversaw the KRS Funds. Defendants (i) directly participated in the transactions, actions and omissions complained of; (ii) aided and abetted one another; and (iii) pursued a conspiracy and concerted common course of conduct and joint enterprise damaging KRS, its Funds and Kentucky taxpayers. The claims made are based solely on Kentucky pension law, trust law, common law and other Kentucky statutory laws. There are no federal claims asserted.

**A. KRS WAS FULLY FUNDED WITH A SURPLUS IN 2000 – NOW IT IS IN A \$25-50 BILLION HOLE**

3. In 2000-2001, the KRS<sup>3</sup> pension plans (referred to variously as the "Pension Plans" or "Plans" or "Trust Funds" or "Funds") overseen and managed by KRS, for 350,000 present and former state and local government employees – police officers, clerks, janitors, prosecutors, correction officers, social workers, librarians,

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<sup>3</sup> KRS invests the assets of insurance benefit plans for each of the KRS Pension Plans, in a portfolio referred to as the "KRS Funds," which includes those funds held and invested for both the pension and insurance plans as well.

etc. – were over 100% fully funded, with a \$2 billion surplus. The retirement and health care benefits of those Kentucky workers were secure.

4. Today, the KRS Plans are in danger of failing. They are the worst-funded public pension plans in the United States. The largest of the Plans, which was 139% funded in 2000, now has only 13.6% of the money it needs to pay the billions of dollars it owes. In other words, it is now a mere one-tenth of the funding it had seventeen years ago. Its \$2 billion surplus in 2000 is gone, and has been replaced by a \$13.5 billion deficit. Its assets have fallen to just \$1.9 billion, yet it has to pay out almost \$1.0 billion in benefits each year going forward for decades. One advisor told KRS that the largest Plan will be insolvent “in very short order.” One official has admitted that absent a massive taxpayer bailout, “the funds will fail ... the run-out date – the date when the fund would be depleted ... has shrunk to two years and 10 months.” Estimates of the current overall KRS funding deficit are at least \$27 billion. They are likely closer to \$50-plus billion, much larger than the Funds’ total assets of approximately \$15 billion.

#### **B. THE 2000s BRING HUGE LOSSES, HORRIBLE INVESTMENT PERFORMANCE AND FUNDING DEFICITS**

5. In 2000-2001, KRS lost \$2.2 billion in investments (over 20% of the KRS Funds’ assets). In 2008-2009, KRS lost over \$4.4 billion (over 30% of the KRS

Funds' assets). After these losses, the trustees<sup>4</sup> received studies which revealed that the financial condition and liquidity of the Funds were seriously threatened and far worse than was publicly known. The trustees had been utilizing outmoded, unrealistic and even false actuarial estimates and assumptions about the Pension Plans' key demographics, *i.e.*, retiree rates, longevity, new hires, wage increases, inflation. For example, Trustees used an assumed 4.5% yearly governmental payroll growth when new hiring rates were near zero or negative and interest rates were too. Most importantly, KRS' assumed annual rate of investment return ("AARIR") of 7.75% was not realistic.<sup>5</sup> Nevertheless, Trustees and other Defendants continued to use assumptions that were proven to be dead wrong by the actual figures established since 2000. From 2000 through to date, the Funds' cumulative moving average annual rate of return has never even come close to that "assumption." That is not a mistake or a bad estimate. It is deliberate concealment.

6. Between 2000 and 2016, the KRS Plans achieved the following actual annual rates of return on investments<sup>6</sup> (negative returns are shown **in red**):

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<sup>4</sup> As used herein, the term "the trustees" includes those trustees who were serving at the time of the events referenced, which may, but does not always include any or all of the named Trustees. The trustees named in this action as defendants will generally be referenced as "Trustee."

<sup>5</sup> Over the relevant time period KERS used AARIRs of 8.25% (6/30/01 – 6/30/06), 7.75% (6/30/06 – 6/30/15) and 7.50% after 6/30/15; amid recent disclosures the AARIR has been cut even further to 5.75%. For simplicity, and because 7.75% was used throughout the bulk of the relevant time periods, we use 7.75% throughout, unless the difference matters.

<sup>6</sup> The data in this chart, and in charts and throughout this Complaint, is the cumulative moving average of the actual returns from the year 2000 forward to each respective year end, unless the context clearly states to the contrary.

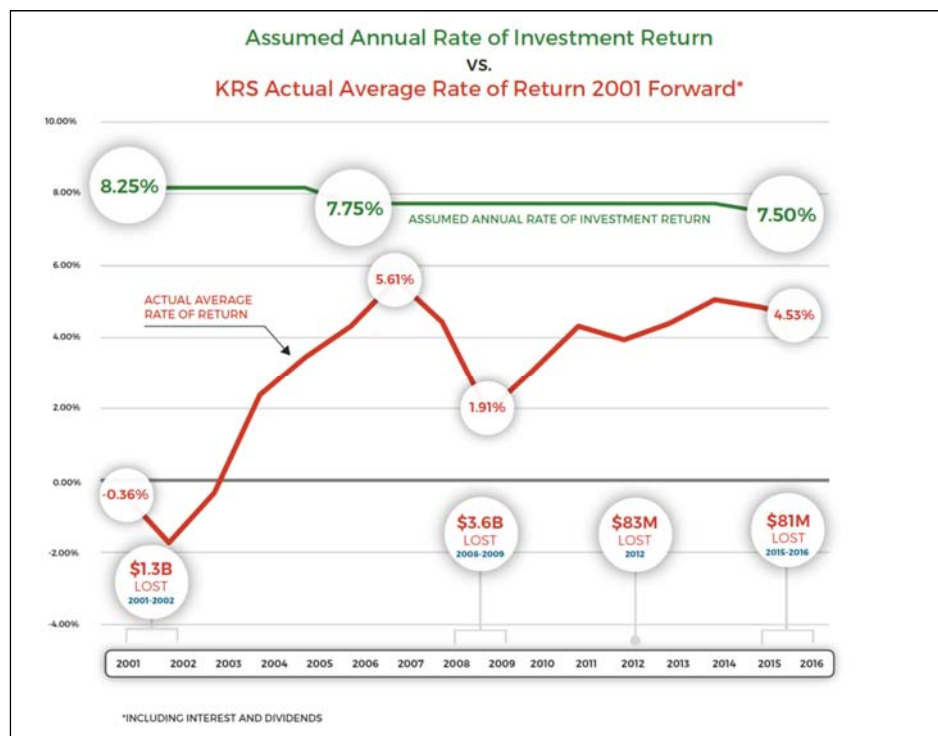
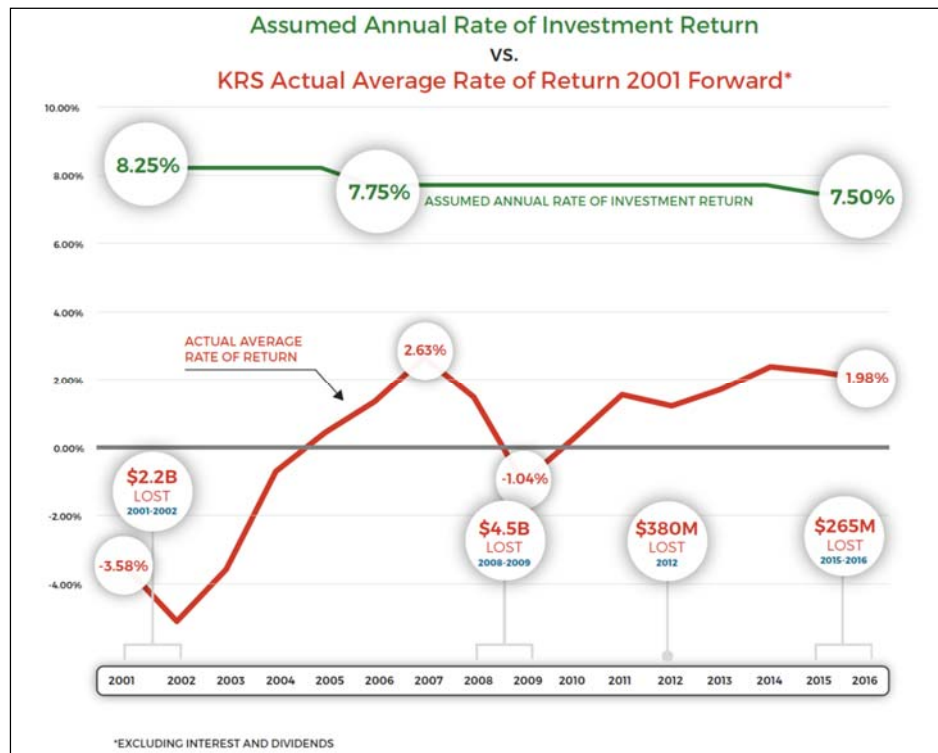
<u>YEAR</u>	<u>Excluding Interest/Dividends</u>	<u>Including Interest/Dividends</u>
2000	+1.82%	+4.91%
2001	-3.58%	-0.36%
2002	-5.12%	-1.74%
2003	-3.60%	-0.35%
2004	-0.73%	+2.38%
2005	+ 0.41%	+ 3.45%
2006	+ 1.32%	+ 4.32%
2007	+ 2.63%	+ 5.61%
2008	+ 1.45%	+4.44%
2009	-1.04%	+ 1.91%
2010	+ 0.21%	+3.08%
2011	+ 1.52%	+ 4.32%
2012	+ 1.19%	+ 3.94%
2013	+1.68%	+ 4.40%
2014	+ 2.36%	+ 5.06%
2015	+ 2.21%	+4.85%
2016	+ 1.98%	+4.53%

7. By 2009, the KRS Plans had achieved an average annual rate of investment return of **negative -1.04%** (excluding dividends/interest) and only positive +1.91% (including dividends and interest) since 2000 – a ten-year period. KRS' AARIR never recovered from the \$6.6 billion in investment losses between 2000-2009.<sup>7</sup> The use of a 7.75% AARIR going forward was in disregard of the KRS Funds' own actual investment record and willfully reckless. The actual KRS' investment record and performance demonstrated to all Defendants that the 7.75% AARIR used by the KRS Trustees, and upon which so much else depended, had been unrealistic and unachievable and would be going forward on an ongoing basis.

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<sup>7</sup> If an investment is worth \$50 and falls to \$25, your loss is 50% or \$25. Just to get back to even, your remaining \$50 of investment money must go up 100%. Then to make up the AARIR for both years, you need the equivalent of two 7.75% returns on top of that. Losses of the magnitude suffered by the KRS Funds could not be made up with another AARIR of 7.75%.

The graphs below show how unrealistic it was to continue use of the AARIR of 7.75%:





### **C. THE 2009-2010 FINANCIAL/ACTUARIAL VISE AND KRS' BOARD AND STAFF PERSONNEL CRISIS**

8. While the trustees were attempting to deal with the largest investment losses KRS had ever suffered (\$6.6 billion in just a few years), they were also facing (i) a significant increase in retirees, requiring the Plans to start paying out increasing amounts of benefits to retirees, who were living ever longer lives; and (ii) slowing growth in government hiring, *i.e.*, fewer new members (and fewer wage increases) to provide needed fresh money to the Plans.

9. In 2009-2010, KRS was also suffering from serious Board turmoil and staff turnover. A special audit had uncovered \$12-15 million in “suspicious payments” (now statutorily illegal payments) to mysterious placement agents, much of it in connection with KRS’ first ever “investment” of over \$100 million in two exotic hedge fund-like vehicles sold to KRS by financial firms in 2010 (in which KRS suffered large losses). The KRS Chief Investment Officer (“CIO”) and Executive Director (“ED”) were both fired. The Board Chair, a retired highway patrolman, was removed, but permitted to remain on KRS’ Investment Committee. This left Trustees to face the financial/actuarial crisis with an interim ED who had no investment experience or expertise, plus a new Board Chair, new Chief Investment Officer (“CIO”), a new Director of Alternative Investments, and a compromised Investment Committee. None of these individuals had experience or expertise in

“absolute return” funds of hedge funds, the Black Box<sup>8</sup> vehicles the Hedge Fund Sellers were about to sell to KRS.

10. In 2009-2010, as KRS’ Trustees tried to deal with the huge investment losses with a disrupted Board and decimated staff, the KRS Plans’ internal demographics continued to deteriorate: more retirees, living longer, fewer new plan members, lower pay increases, and much lower investment returns than the published 7.75% AARIR. Trustees realized that, even if the KRS Funds could somehow earn 7.75% per year going forward forever, the Plans were going to face a serious liquidity squeeze.

11. By 2010, the KRS Trustees and officers were caught in a tightening financial/actuarial vise. Having suffered over \$6.6 billion in investment losses in seven years (which would penalize returns at least until 2014), they now had to find a way to pay ever increasing numbers of longer-living retirees, with fewer and fewer new plan members contributing wage assessments, all in a “zero” interest rate environment. They and their investment, actuarial and fiduciary advisors realized that the Plans would likely not have the money to pay the promised and legally-obligated pensions even assuming the Funds earned the published, but now known by them to be completely unrealistic, AARIR of 7.75% per year, every year, forever

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<sup>8</sup> “Black Box” hedge funds are vehicles where the “investor” knows little if anything about the contents of the vehicle or how the money is being “invested.” This secrecy is usually based on a claim by the hedge fund seller/manager that the methods, strategies and fees of the fund are sophisticated, secret and successful and thus are claimed to be proprietary and cannot be disclosed for fear of losing claimed competitive advantages.

going forward. All defendants also realized that if they honestly and in good faith factored in and disclosed realistic actuarial assumptions and estimates and investment returns, the admittedly underfunded status of the Plans would skyrocket by billions of dollars overnight, that there would be a huge public outcry, that their stewardship and services to the Funds would be vigorously criticized, and that they would likely be investigated, ousted, and held to account.

#### **D. DEFENDANTS CHOOSE TO COVER UP AND PLAY CATCH UP**

12. Contrary to their obligations of truthful disclosure in “easily understood” language as mandated by the Kentucky pension statute, Trustees, with the knowing assistance of all the other Defendants, chose to cover up the true extent of the KRS financial/actuarial shortfalls and take longshot imprudent risks with KRS Funds to try to catch up for the Funds’ prior losses and deceptions. They misled, misrepresented and obfuscated the true state of affairs inside KRS from at least 2009 forward.

13. The trustees had also chosen to spread the \$2.2 billion in investment losses in 2001-2002 over the following five years, and did the same with the \$4.4 billion in losses in 2008-2009. With these huge losses already in place, the trustees were facing a severe crisis caused by their reckless assumptions. Trustees and other Defendants made representations in KRS Annual Reports to members and Kentucky taxpayers directly contrary to the actual actions of Trustees and other Defendants, stating that: “(i) ... the Board follows a policy of thoughtfully growing our asset base while protecting against undue risk and losses in any particular

investment area. The Board recognizes its fiduciary duty ... to invest the funds in compliance with the Prudent Person Rule; (ii) “its investment decisions ... [are] the result of conscious exercise of discretion ... and that proper diversification of assets must be maintained”; (iii) “through these policies” that KRS has been able to provide “significant returns” ... while “holding down,” [and] “minimizing investment expenses”; (iv) and that the KRS Annual Reports to members and taxpayers “would provide complete and reliable information as a means for determining compliance with statutory provisions and as a means of determining responsible stewardship of KRS funds.”

#### **E. THE KRS TRUSTEES ARE TARGETED BY THE HEDGE FUND SELLERS**

14. As Trustees searched for a way out of the serious financial/actuarial crisis they knew the Plans were in, they presented a tempting target for the Hedge Fund Seller Defendants. “Hedge funds” is a term that encompasses private (not publicly traded) investment vehicles often structured as limited partnerships, employing what are called “alternative investment strategies” as opposed to conventional investments, such as equities, bonds and mutual funds. But the Hedge Fund Sellers sold the KRS Trustees something far more exotic, risky, toxic and expensive than an ordinary hedge fund. They sold them hedge funds that invest in *other hedge funds*. Hedge fund sellers like to call these hedge funds “absolute return assets” or “absolute return strategies,” indicating they always provide positive returns – which they most certainly don’t. These funds are also sometimes referred to as “funds of funds” or “funds of hedge funds” vehicles. More accurately they are

called “Black Boxes” because the investor does not know what these downstream funds put the investors’ money into, how they invest this money, what the true fees are or how they are shared among the various funds involved in the chain of funds. Further, the investor does not have any way to objectively and independently monitor the investing practices of the downstream funds or to determine or accurately measure the value of their holdings. “Black Boxes” are secretive and opaque because of the layers of secrecy placed between the investor and the investment, as downstream fund managers claim their methods, strategies and fees are “propriety,” “secret” and cannot be shared. When Trustees were sold these vehicles, they lacked adequately trained, experienced staff with expertise in fund of hedge funds to assist them.

15. Hedge fund sellers, managers, and consultants, like Hedge Fund Sellers here, have found a lucrative victim in the trustees of many public pension funds, as was documented in “ALL THAT GLITTERS IS NOT GOLD: AN ANALYSIS OF US PUBLIC PENSION INVESTMENTS IN HEDGE FUNDS,” Roosevelt Institute, November 16, 2015. This extensive study concluded that the poor investment returns of hedge funds cost the eleven public pension funds studied \$8 billion in lost investment income while the excessive fees of the hedge funds cost the pension funds \$7 billion. The study found that hedge funds provided no protection (or hedge) against volatility and downside loss. And for every \$1 of investment returns, the hedge fund fees were an astonishing \$.57. The Report concluded:

Our analysis suggests that, despite promises of better and less correlated returns, hedge funds failed to deliver significant benefits to any of the pension funds we reviewed. Instead, our findings suggest that hedge funds

collected billions in disproportionately high fees that do not appear justified by performance, while costing public pension funds – and the public employees and taxpayers who fund them – additional billions in lost investment revenue.

\* \* \* \* \*

Indeed, our findings suggest that all 11 pension funds included in our analysis would have performed better having never invested in hedge funds in the first place. This has important implications not only for pension fund trustees, who have a fiduciary duty to prudently seek investments that provide the highest long-term returns for the lowest cost to the pension fund, but also for public employees, public employee unions, retirees and taxpayers ... [who] should be concerned about this overall negative impact that hedge funds are exerting on public pension funds.

16. In August 2011, Trustees were sold \$1.2 - \$1.5 billion (in three extremely large commitments, each between \$400 and \$500 million) in Black Box fund of hedge funds vehicles. Reflecting what Trustees had been told, KRS' Chief Investment Officer ("CIO") announced that these investments were "Absolute Return" assets, an "absolute return strategy" which would "reduce volatility" ... [get KRS to] an expected rate of return of 7.75% ... [and which] lowers our risk." According to KRS' investment advisor RVK, Trustees had decided on the "most effective asset allocation strategies for each pension and insurance plan ... in order to lower risk, control the level of illiquidity in the portfolios and generate a return expected to exceed the actuarial assumed rate of return 7.75%" [and] "with new allocations to the ... absolute return buckets ... going forward the portfolio is more diversified than ever."

17. These unsuitable "investments" did not lower risk, reduce illiquidity, or generate sufficient returns to enable KRS to even approach, let alone exceed, the assumed rate of 7.75% on an on-going basis. They did generate excessive fees for

those Hedge Fund Sellers, poor returns and ultimately losses for the Funds, in the end damaging KRS and Kentucky taxpayers.

18. These funds of hedge funds Black Boxes were sold to KRS by sophisticated, high-powered financial firms, headquartered in Wall Street and Los Angeles and operating all over the world: KKR, KKR/Prisma, Blackstone and PAAMCO (each defined below in Section III, collectively referred to as the “Hedge Fund Sellers”<sup>9</sup>). Each of these firms targeted underfunded public pension funds like KRS. To them, KRS was a potential buyer of the exotic, high-fee and high profit hedge fund vehicles they sold. The Hedge Fund Sellers nicknamed these vehicles the “Daniel Boone Fund,” “Henry Clay Fund,” and “Newport Colonels Fund” (“Colonels” Fund”) because they were specially designed and created for Kentucky.

19. These funds of hedge funds were extremely high-risk, secretive, opaque, high-fee and illiquid vehicles. They were the largest, single one time “investments” (individually or collectively of one asset class) ever made by KRS. Trustees took this gamble even though these “Black Boxes” had no prior history of investment performance, and, because of their secrecy, were impossible for Trustees to properly monitor, accurately value or even calculate the total fee burden.

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<sup>9</sup> “Hedge Fund Sellers” as used in this Complaint means KKR, Kravis, Roberts, Prisma, Reddy, Blackstone, Schwarzman, PAAMCO and Buchan for all periods after 2011 and refers to Prisma, Reddy, Blackstone, Schwarzman, PAAMCO and Buchan for periods prior to 2012. It should be understood that events prior to 2012 are at this point only alleged to be the responsibility of KKR, Kravis or Roberts to the extent KKR may have acquired the liabilities of Prisma upon its acquisition of Prisma.

## **F. THE 2016/2017 REVELATIONS AND NEAR COLLAPSE OF THE FUNDS**

20. During 2016-2017, the funded status of the KRS Plans plunged even further. Investigative journalists and an independent investigation revealed losses, excessive fees and the past use of outmoded, unrealistic, and false actuarial assumptions. KRS has slashed its AARIR to much lower levels. In 2017, three of the highest elected officials of the Commonwealth, the Governor (Matt Bevin), the House Speaker (Jeff Hoover) and the Senate President (Robert Stivers) jointly wrote:

“The biggest cause of the shortfall was erroneous actuarial assumptions made by past members of the boards of these systems, which led to significant underfunding ...

...past assumptions were often manipulated by the prior pension boards in order to minimize the “cost” of pensions to the state budget. Unreasonably high investment expectations were made and funding was based on false payroll numbers.

The result was to provide a false sense of security and justify smaller than necessary contributions to the pension plans. This was a morally negligent and irresponsible thing to do.”

## **G. ACCOUNTABILITY IS REQUIRED**

21. The huge underfunding and near financial collapse of the Plans has occurred despite Kentucky taxpayers pouring billions of dollars into KRS in recent years, causing an increasingly large drain on the Kentucky Treasury and contributing to significant curtailments of social and educational spending. Trustees and Officers, as part of their course of misconduct with the other Defendants, have operated KRS in violation of law. They failed to follow legal mandates regarding the safeguarding and prudent investment of trust monies for which they were



responsible, consisting of both pension funds and tax dollars, wasting billions of tax dollars and damaging KRS, its Pension Funds and the Kentucky taxpayers. The need for billions more in tax dollars to save KRS will continue. According to recent calculations, the Commonwealth's support for KRS will have to increase by almost one billion dollars per year going forward indefinitely. Because of the KRS fiasco, Moody's and Standard & Poors have slashed Kentucky's credit rating, leaving Kentucky with the worst, or one of the worst, credit ratings of any state, while also facing massive tax increases. KRS and Kentucky taxpayers should not bear the damage caused by Defendants' breaches of duty and misconduct. That is properly the Defendants' legal responsibility.

22. If Trustees and Defendants working in concert with them had told the truth in 2010, as the law required, and had they then in good faith used realistic estimates and assumptions, as the law required, the damage caused to KRS could have been avoided or greatly lessened and the price tag now facing the taxpayers would be billions less.

23. The current Board cannot and will not sue themselves or their alleged co-actors and any demand that they bring this suit would be a useless act. All Trustees have been involved in the wrong-doing and will not subject themselves to suit or public exposure and scrutiny. The legal status of the KRS Board, and its power to act, is itself in doubt, because of ongoing lawsuits and disputes between the Attorney General, certain KRS Trustees and the Governor, challenging the

legality of the board's composition. Any demand that the current Board of Trustees bring these claims on behalf of KRS would be futile.

24. Plaintiffs have made demand in writing upon the Attorney General of Kentucky to assert the taxpayer claims set forth herein and that demand was declined. Plaintiffs bring their taxpayer action under two alternative theories: first, demand made upon the entity authorized by law to bring the claims was declined; second, in their own right as taxpayers for Kentucky Taxpayers, regardless of any action, inaction or inability to act of the Attorney General. For the foregoing reasons, Plaintiffs proceed on the taxpayer claims in *parens patriae*.

25. The crisis that engulfs KRS and the Commonwealth of Kentucky is not due to any fault of the Kentucky workers or taxpayers whose wages and tax dollars have funded the Plans for over 60 years. KRS, its Plans and Funds, and Kentucky taxpayers are innocent victims. Plaintiffs, who are beneficiaries and members of KRS Pension and Trust Plans and Kentucky taxpayers, bring this action (1) derivatively, on behalf of, and for benefit of, KRS and its Funds and (2) as a taxpayer action for the benefit of the taxpayers of the Commonwealth of Kentucky, in their own right or based on the declination of the Attorney General to bring such claims. The suit seeks to hold Defendants responsible for their (i) individual liability for breaches of trust, fiduciary, professional, common law and statutory duties, and/or their aiding and abetting other Defendants' breaches of their duties and their (ii) collective and joint liability for aiding and abetting one another and participating in a scheme, civil conspiracy and concerted common course of conduct

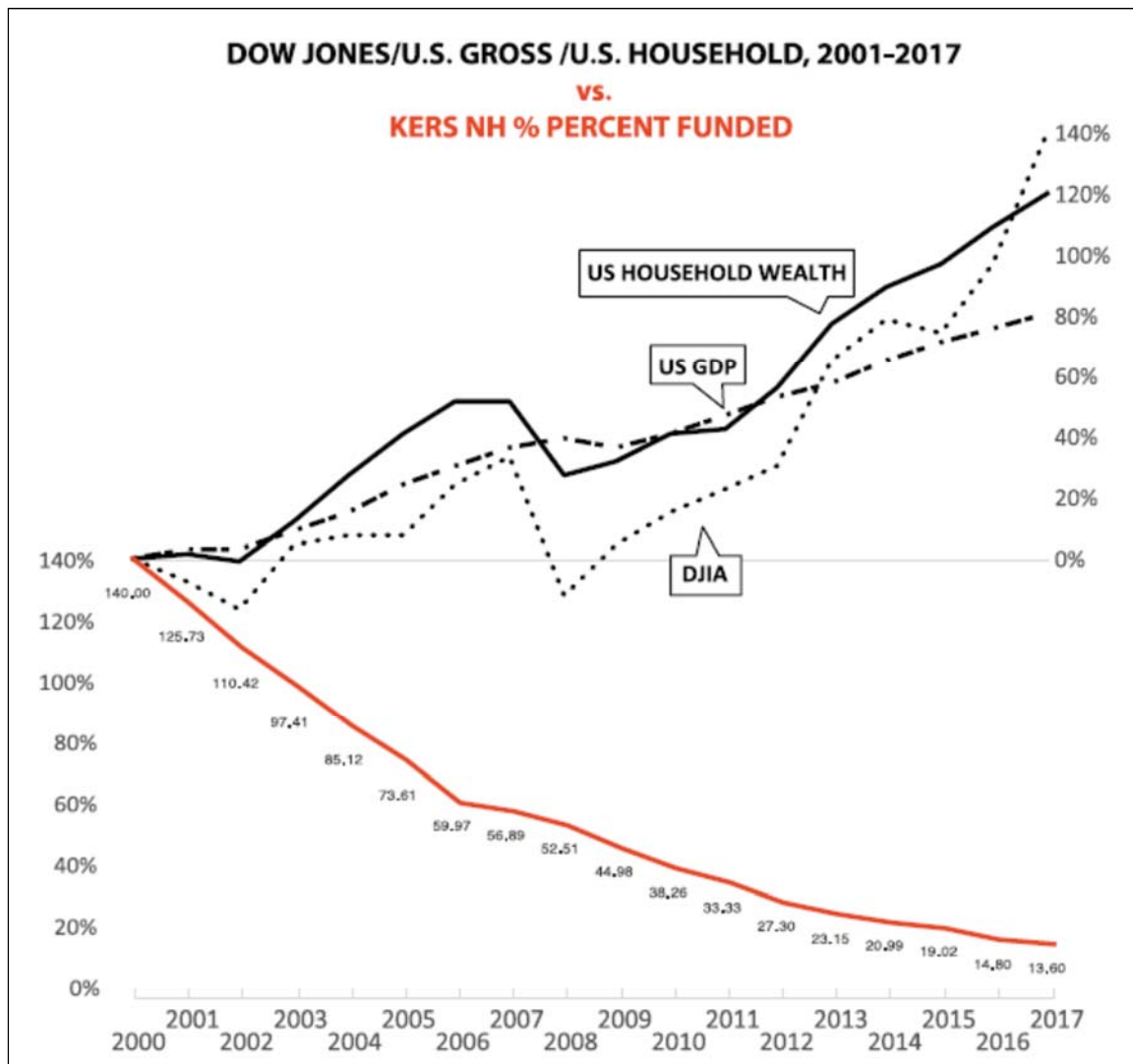
and joint enterprise, which damaged KRS, its Funds and the taxpayers of Kentucky.

26. The actions and failures to act of Trustees and Officers named herein are not protected by sovereign immunity. Under Kentucky statute and case law KRS has the power to sue and be sued. This action is brought on behalf of KRS by members and beneficiaries asserting claims for injunctive relief and monetary damages against Trustees and Officers and other third parties named as Defendants. No monetary damages are sought from the Commonwealth. Trustees are not employees of the Commonwealth. Liability of Trustees is expressly recognized by statute upon a showing under KRS 61.645(15)(e) and (f), which is sufficient to allow an award of monetary damages against Trustees. Trustees' and Officers actions and failures to act were violations of their mandatory duties under Kentucky law.

27. In 2013, KRS, its members and beneficiaries and all Kentucky taxpayers were assured by the elected officials then in power that legislation had been passed that "fully honor[ed] the commitments made to state workers and retirees...[and] ... address[ed] the financial uncertainty that threatened our State's credit rating." Defendants' actions and failures to act are not barred by any statute of limitations or laches. The wrongdoing of all Defendants is ongoing and has been concealed sufficiently to suspend the running of any limitations period. Plaintiffs have never been sent a report that adequately described the existence of a claim for breach of trust against Trustees or of any claims against the other Defendants, or

that informed them of any time limit within which to file a claim.

28. The financial consequences of the wrongdoing here can be stated and displayed simply. The country is at the top of one of the longest, largest “bull markets” in history. Markets are at all-time highs after one of the longest economic expansions in history, pushing U.S. household wealth to an all-time high, as graphically depicted here:



29. Yet, the KRS Pension Plans are \$25-50 billion underfunded and facing collapse. According to the new Chair of the KRS Board, John Farris, was quoted as saying:

KRS made serious math errors in recent years, relying on overly optimistic assumptions about its investment returns, the growth of state and local government payrolls. We have been aggressively wrong in our assumptions for many years.

...

It doesn't make any sense ... We wonder why the plans are underfunded. It's not all the legislatures fault. It's the board's responsibility to give the correct numbers. ...

Payroll growth was negative and you assumed 4% growth? Were any of you paying attention?

30. The KRS year-end 2017 financial results were just formally released. As a result of the misconduct of Defendants as alleged herein, \$800 million in taxpayer funds over and above the 2017 amount of one billion dollars will be needed in 2018 alone to try to prop up the funds. This almost one billion dollars increase over last year's contribution of one billion taxpayer dollars, will have to continue for many more years:

"The massive dollar amounts came as no surprise and are largely a result of new assumptions ... lowering projections on how much the plans will earn on investments and on how much government payrolls are expected to grow."

John Farris, [The New] Chairman of the Board, said the new assumptions replace optimistic ones used by boards in the past that caused Kentucky Retirement Systems to not ask for sufficient funding which led to the accumulation of billions in unfunded liabilities.

"Now we're giving the right numbers. Lots of complaints about the right numbers. I understand it ... I wish it wasn't that way. I wish they were given the right numbers 10 years ago."

## **II. JURISDICTION, VENUE, REMOVABILITY, AND STATUTE OF LIMITATIONS/LACHES**

31. This court has subject matter jurisdiction over the claims pursuant to Kentucky Revised Statutes (hereinafter, “Ky. Rev. Stat. §”<sup>10</sup>) 23A.010.

32. Venue is proper in this court because the claims asserted herein arose in Franklin County, Kentucky.

33. This action is not removable to federal court for many reasons, including:

- a. There is not complete diversity of citizenship. All Plaintiffs and many of the Defendants reside in, and are citizens, of the Commonwealth of Kentucky.
- b. This suit involves a local controversy vital to Kentucky workers and taxpayers over the Kentucky Retirement Systems and its Trust Funds, a component unit of the Commonwealth of Kentucky and the public employee pension and insurance plans it oversees: The Kentucky Employee Retirement System, County Employees Retirement System and State Police Retirement System.
- c. This action is not a class action. It does not assert any harm to KRS members or beneficiaries individually and it does not seek any relief for them individually or collectively as a class. This is not a mass action for individual taxpayers but rather on behalf of the Commonwealth. No taxpayer seeks, nor will any taxpayer receive, any individual recovery in this action. The action is an entirely derivative one for KRS and/or its Funds and on behalf of the Commonwealth of Kentucky.
- d. Plaintiffs assert only claims arising under Kentucky law, including Kentucky’s pension, trust, and other laws. Plaintiffs do not assert any claims under federal law or regulation, and to the extent any claim or factual assertion herein may be construed as stating a federal claim, Plaintiffs disavow that

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<sup>10</sup> This abbreviation is used in lieu of the more commonly used “KRS,” to avoid confusion with the Kentucky Retirement System. As used herein, the acronym “KRS” refers to the Kentucky Retirement System.

claim. KRS, its trustees and its Funds are not subject to federal regulation. Taxpayer claims on behalf of a state cannot be removed to or litigated in federal court.

- e. Breaches of duty and misconduct occurred in Kentucky and involve the operations and functioning of Pension and Insurance Plans located in and organized under Kentucky law. More than 94% of the members and beneficiaries of these pension plans reside in Kentucky.

34. The court has personal jurisdiction over each Defendant. The Court has personal jurisdiction over those Defendants not residing in Kentucky pursuant to Ky. Rev. Stat. §454.210, as each meets the statutory definition of a “person,” and these claims arise from the actions of each “directly or by an agent” in that each Defendant regularly transacted and/or solicited business in the Commonwealth and/or derived substantial revenue from goods used or consumed or services rendered in the Commonwealth and/or contracted to supply good or services in the Commonwealth and/or caused injury by an act or omission in the Commonwealth and/or caused injury in the Commonwealth by an act or omission outside the Commonwealth.

35. The size of the Black Box sales – \$400-\$500 million for each of three Black Box funds – was extraordinarily large. Because of the size of these sales, in selling their respective funds of hedge funds vehicles to KRS and dealing with KRS thereafter, KKR/Prisma, Blackstone and PAAMCO’s top executives, or their designees and agents, handled the sales process to KRS and the ongoing “servicing” of the account, which included their personal presence in Kentucky in connection with these KRS investments, “over a period of years.”

36. The wrongs complained of are continuing and ongoing. Defendants have actively concealed their wrongdoing and violations of law for years, including publishing a KRS Annual Report in which they are each identified and each was aware of and that as late as 2016 was certified by the Government Finance Officers Association as “satisfying applicable legal requirements.” In 2013 legislation was passed to strengthen the KRS Pension Funds. KRS beneficiaries and Kentucky taxpayers were assured “As a result of this legislation, we fully honor the commitments made to state workers and retirees...[and] “address the financial uncertainty that threatened our State’s credit rating.” The statute of limitations cannot run against KRS when that entity has been under the control of the wrongdoers. This action is filed within five years of discovery of the violation of the rights of KRS and its Plans, and the rights of the Commonwealth and its taxpayers. None of the Plaintiffs nor any member of any of the Plans has ever been sent a report that adequately described the existence of a claim for breach of trust against Trustees and that informed them of any time limit to file a claim.

### **III. THE PARTIES**

#### **A. PLAINTIFFS**

37. Jeffrey C. Mayberry was a Kentucky State Police Trooper, Sergeant, Lieutenant and Captain from 1986 to 2011, and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

38. Hon. Brandy O. Brown was a law clerk, an employee of the Administrative Office of the Courts (1993-1995), and Assistant County Attorney (1995-2001), and is now a member of the judiciary in the 25<sup>th</sup> judicial circuit and is



a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

39. Martha M. Miller was a Deputy Court Clerk from November 1977 to 2015 and Chief Deputy Court Clerk from 2015 to the present, and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

40. Steve Roberts was a City of Richmond, Kentucky, EMT/ Firefighter from September 1981 until September 2014, and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

41. Teresa M. Stewart is an employee of the Department of Health and Human Services where she is employed as a social worker and has been since 1996. Ms. Stewart and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

42. Don D. Coomer was a Louisville, Kentucky Fire Company Commander from 1971 to 2000 and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

43. Jason Lainhart worked in the Kentucky Department of Military Affairs (1995-1997), the Louisville Kentucky Police Department (1997-2016), and the Kentucky National Guard (1992-2010), and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

44. Ben Wyman was a law clerk in the Jefferson County Attorney's Office commencing on March 19, 1999, and then became an assistant County Attorney in

that office on April 20, 2001, and left his employment with that office on March 21, 2016, and is a member of KRS and one or more of the Plans and was at the time of one or more of the wrongdoings alleged.

45. Each of the Plaintiffs are residents and citizens of Kentucky and Kentucky taxpayers as well.

## **B. DEFENDANTS**

### **NOMINAL DEFENDANT KRS**

46. Nominal Defendant KRS<sup>11</sup> is a component unit of the Commonwealth of Kentucky created and organized under Kentucky Law pursuant to the 1956 Pension Law to contain Trust Funds held for several pension plans (defined herein previously as the “Pension Plans” or the “Plans”) for Kentucky workers:

**KERS (Kentucky Employee Retirement System):** this system consists of two plans – **Non-hazardous and Hazardous**. Each plan is a cost-sharing multiple-employer defined benefit pension plan that covers all regular full-time members employed in positions of any state department, board, or agency directed by Executive Order to participate in KRS.

**CERS (County Employee Retirement System):** This consists of two plans—**Non- hazardous and Hazardous**. Each plan is cost sharing multiple-employer defined benefit pensions plan that covers all regular full-time members employed in non-hazardous positions of each participating county, city and school board, and any additional eligible local agencies electing to participate in CERS.

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<sup>11</sup> To the extent this action, for whatever reason, need be construed as a derivative action on behalf of the KRS Trust Funds or KRS Plans, as opposed to KRS itself, Plaintiffs ask it to be so construed. The recovery from this action will not be individual recoveries but rather will be for the benefit of the Trust Funds of KRS and for the Commonwealth, and should, as Plaintiffs request, be under the supervision of this court or a special fiduciary appointed by this court, to assure that all monies are applied properly and in accordance with law.

**SRS (State Police Retirement System):** This system is a single-employer defined benefit pension plan that covers all full-time state troopers employed in positions by the Kentucky State Police.

47. While KRS is designated a “Defendant,” that designation is a technical formality, *i.e.*, it is a “nominal defendant.” In reality, KRS is the plaintiff in this action, which is on behalf of, not against, KRS and in order to obtain relief for it, not from it or from any other unit or part of the government of the Commonwealth of Kentucky.

#### **KRS TRUSTEE AND OFFICER DEFENDANTS<sup>12</sup>**

48. Defendant William S. Cook has been a Trustee of KRS from September 15, 2016 to the present. Cook is currently a member of KRS’ Investment Committee. He served as Chair of the Investment Committee from October 14, 2016 through August 22, 2017. For over seventeen years, Cook was an executive with Aegon USA, a Kentucky-based company owned by Prisma, where he specialized in selling hedge funds. In 2004, Cook joined Prisma Capital Partners, L.P. (“Prisma”) as it was being formed in New York City by Aegon and three former Goldman Sachs partners, and Defendant Girish Reddy. Cook became an executive director of Prisma, had a multi-million-dollar financial interest in Prisma and was a member of the Prisma Investment Committee, which included the other four top officers of Prisma. Cook retired from Prisma in 2015. Cook was at Prisma when it created and sold the

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<sup>12</sup> As mentioned in footnote 5, there are a number of references throughout this Complaint to the entire group of trustees of KRS from the mid-2000s through to date. Those references are for context, and may but do not necessarily include named Trustees. The trustees named in this action as defendants will generally be referenced as “Trustee,” while the Board of KRS, or all trustees then serving will be referenced as “the trustees.”

“Daniel Boone Fund” to KRS. Cook retains a multi-million-dollar financial interest in KKR/Prisma, the combined firm formed in 2012 when KKR & Co. L.P. (“KKR”) acquired Prisma (the combined firm is referred to as KKR/Prisma).

49. Cook is close personal friends with KKR/Prisma’s top officials including Girish Reddy. Cook helped arrange for KKR/Prisma to act as an investment advisor to, and manager for, KRS with respect to the investment of its overall hedge fund “investments.” Cook arranged for a KKR/Prisma executive to work inside KRS, while still being paid by KKR/Prisma. Cook’s presence on the KRS Board and the presence of KKR/Prisma executives inside KRS, and certain other transactions in which he participated, violated and continue to violate the conflict of interest provisions of the Kentucky Pension Law.

50. Defendant Randy Overstreet, a retired highway patrolman, was a Trustee of KRS from 1995 through 2015. He served as Chair from 1997 until 2011 when he was removed as Chair following the huge 2008-2009 losses and the discovery of \$12-15 million in “suspicious” placement agent “fee” payments. Overstreet was again appointed Chair in 2013. Defendant Overstreet was permitted to stay on the Investment Committee even when demoted as Chair, serving on that committee from 2010 through 2011, and again 2013 through 2014.

51. Defendant Timothy Longmeyer was Trustee of KRS from April 1, 2010 through 2015 and on the Investment Committee from 2010 through 2013, including when KRS was sold the Black Boxes by the Hedge Fund Sellers. He recently pleaded guilty to taking a bribe in connection with the award of a

consulting contractor for a government entity and has been sentenced to 70 months in jail.

52. Defendant Bobby D. Henson was a Trustee of KRS from approximately 1998 through 2014, including when KRS was sold the Black Boxes by the Hedge Fund Sellers.

53. Defendant Thomas Elliott has been a Trustee of KRS from at least April, 2011 through the present. T. Elliott was the Chair of KRS from May 2012 to April, 2013 and on the Investment Committee from his appointment through 2017, including when the Black Boxes were sold to KRS by the Hedge Fund Sellers.

54. Defendant Jennifer Elliott was a member of the Board of Trustees of KRS from 2009 through October 2012. She was Board Chair after Overstreet was demoted until 2012. J. Elliott was Chair of the Board and also on the Investment Committee when the Black Boxes were sold to KRS by the Hedge Fund Sellers.

55. Defendant Vince Lang was a Trustee of KRS from April 2005 through 2013, and again from 2014 through to the present. Lang was Chair of the Investment Committee from at least February 2010 through April 2011, and on the Investment Committee from 2010 through 2013 including when the Black Boxes were sold to KRS by the Hedge Fund Sellers.

56. Defendant David Peden was an Officer of KRS from 2009 through early 2017. He was involved in the sales of the Black Boxes to KRS in 2011. Defendant Peden was CIO from January 2014 2013 through the end of his employment. Defendant Peden previously worked at Prisma with Defendant Cook.

57. Defendant T. J. Carlson was an Officer of KRS from February 2011, through November 2013, during which time he served as the Chief Investment Officer. Carlson was CIO of KRS when the Hedge Fund Sellers sold the Black Boxes to KRS. Carlson moved to Texas in 2013. Carlson is subject to the *in personam* jurisdiction of this court pursuant to Ky. Rev. Stat. §454.210(3)(c).

58. Defendant Brent Aldridge was an Officer of KRS from August, 1991 through August 2016. Aldridge was in charge of Alternative Investments at KRS. When Mr. Tosh was fired as CIO, Aldridge was asked to serve as interim CIO during 2009-2010. Aldridge returned to head Alternative Investments even though he had no significant experience or expertise in fund of hedge fund vehicles. He was in that position when the Black Boxes were sold to KRS by the Hedge Fund Sellers.

59. Defendant William A. Thielen was an Officer of KRS from at least July, 2006 through September 1, 2016. Thielen became interim Executive Director (ED) of KRS in April 2011 after the previous Executive Director (Mr. Burnside) was fired in connection with the “fee” payments scandal, and he served as ED from 2012 through 2016. Thielen had no expertise in investments. When the Black Boxes were sold to KRS by the Hedge Fund Sellers, Defendant Thielen was serving as the interim Executive Director.

60. With the exception of Carlson, the individuals named in the foregoing paragraphs are each residents and citizens of Kentucky.

## **HEDGE FUND SELLER DEFENDANTS**

### **KKR, Kravis, Roberts, Prisma and Reddy**

61. Defendant KKR & Co. L.P. (“KKR”) is a large Wall Street financial enterprise which sells “investment” products and provides investment counseling, advice and management services. KKR makes billions of dollars a year in profits selling extremely complex high-risk investment products charging exceptionally high fees. It is paid a percentage no matter how the investment performs. According to KKR, “our hedge fund business is comprised of customized hedge fund portfolios, hedge fund-of-fund solutions ... managed by KKR PRISMA.” At year-end 2015, KKR was worth almost \$50 billion with yearly net income of \$5 billion.

62. In 2012, KKR acquired Prisma (combined company referred to as KKR/Prisma). In 2017, KKR/Prisma combined with Pacific Alternative Asset Management Co. (“PAAMCO”) to create a new firm PAAMCO/PRISMA HOLDINGS. The new firm continues the KKR/Prisma hedge fund business. The reason for this acquisition and combination was the severe consolidation and shrinkage of the hedge fund industry, customer anger, redemptions and the increasingly bad reputation of fund of hedge fund vehicles. This led to ongoing large redemptions of assets under management and slowing sales of new funds because of the poor returns and high expenses of their products. KKR bears ultimately legal responsibility for the liabilities of Prisma and PAAMCO.

63. KKR/Prisma holds itself out as having great sophistication, experience and expertise in financial matters, stating: (i) “Our business offers a broad range of investment management services to our fund investors”; (ii) “We are a leading

global investment firm that manages investments ... including ... hedge funds. We aim to generate attractive investment returns by following a patient and disciplined investment approach”; (iii) “Our investment professionals screen the [potential investment] opportunity and [then] ... proceed with further diligence ... This review considers many factors including ... expected returns ... historical and projected financial data ... the quality and track record of the issuer’s management team ... specific investment committees monitor all due diligence practices”; and (iv) “We monitor our portfolios of investments using as applicable, daily, quarterly and annual analyses.”

64. Defendant Henry R. Kravis co-founded KKR in 1976 and is Co-Chairman and Co-Chief Executive Officer and its Managing Partner. According to KKR’s Annual Report, Kravis is “actively involved in managing the firm and...has more than four decades of and experience financing, analyzing and investing in public and private companies ... [and] As Co-Chief Executive Officer, Mr. Kravis has an intimate knowledge of KKR’s business.”

65. Defendant George R. Roberts co-founded KKR in 1976 and is Co-Chairman and Co-Chief Officer and its Managing Partner. According to KKR’s Annual Report, Roberts is “actively involved in managing the firm ... has more than four decades of experience, financing, analyzing, and investing in public and private companies ... [and a]s our Co-Chief Executive Officer, Mr. Roberts has an intimate knowledge of KKR’s business.”



66. Because of Kravis' and Roberts' status as co-founders, Board Co-Chairs and Co-CEOs of KKR, as well as serving Co-Chairs of its Management Committee, Kravis and Roberts were both in a position to control and did control the day-to-day operations of KKR during the relevant time periods. Through a complex web of private partnerships Kravis and Roberts personally controlled "the management of [KKR's] business and affairs ... rather than through a board of directors ... and are authorized to appoint other officers." Kravis and Roberts could elect all of the Directors of KKR, appoint all officers and control all aspects of KKR's corporate structure and operation, and they did so. Kravis and Roberts were the responsible corporate officers for the selection, oversight, supervision and training of the top officers and personnel of KKR who were involved in the day-to-day dealings with KRS during the relevant time period.

67. Kravis and Roberts are two of the most financially sophisticated and wealthiest people on Wall Street. In addition to the vast wealth they have accumulated, they are each paid about \$60 million per year for running KKR. KKR states in governmental filings that:

"We depend on the efforts, skills, reputations and business contacts of ... our founders Henry Kravis and George Roberts ... the information and deal flow they and others generate during the normal course of their activities ... Accordingly, our success depends on the continued service of these individuals."

68. Defendant Girish Reddy co-founded Prisma in 2004 with Cook and some Goldman Sachs bankers who agreed "it was time for a fund of funds that could tap into pension funds [because] they knew they wanted hedge fund exposure." Prisma was formed to specialize in selling custom-designed Black Box hedge funds

to public pension funds. Before founding Prisma in 2004, Reddy was a partner in the Wall Street firm Goldman Sachs. He makes millions of dollars a year – and has for several years – running Prisma. He was actively involved in creating the Daniel Boone Fund and selling it to KRS for its Funds. Cook worked closely with Reddy at Prisma. Peden worked with them at Prisma.

69. KKR entered the hedge fund business in 2008-2009, but during 2010 - 2011, two KKR hedge fund operations suffered large losses, a serious setback for KKR at the time it was attempting to expand its business to target underfunded public pension funds as customers for high-fee hedge fund products. After those losses, KKR intensified its efforts to get into the fund of hedge fund business because of its very high profit potential, *i.e.*, the opportunity to sell these Black Box vehicles to troubled public pension funds. Beginning in early 2010, Kravis and Roberts began to try to acquire Prisma, which was already successfully targeting pension funds with its custom-designed fund of hedge fund products and producing very rapid growth in assets under management, and consequent profits.

70. Because of the importance of the acquisition of Prisma to KKR, the effort was personally overseen by Roberts and Kravis. “One of the things that was extremely important was whether the team at Prisma would fit into our culture,” Kravis says. “We spent a lot of time discussing this ... We got to know Girish and his team by spending time with them [and spoke] to our management committee at length about this.” The acquisition was completed in 2012.

71. Prisma had targeted troubled, underfunded public pension funds as customers for the exotic investment vehicles it sold. Prisma realized that KRS trustees and officers were dealing with a much more serious financial and actuarial situation than was publicly appreciated. Prisma custom-designed a “Black Box” fund of hedge funds vehicle. It indicated to Trustees and Officers that this Black Box would produce the kind of high investment returns, with downside protection and safe diversification, that Trustees and Officers were seeking to cover up their own malfeasance, and would make up for past losses, while providing safe diversification. Prisma nicknamed this fund the “Daniel Boone Fund,” because it targeted and was designed for the workers of Kentucky who were members and beneficiaries of KRS.

72. During their efforts to acquire Prisma and their intimate involvement in its business as the Co-CEO’s of KKR/Prisma thereafter, Roberts and Kravis acquired knowledge about Prisma, the strategy by which Reddy and Prisma were producing rapid and profitable growth by targeting troubled pension funds, including the very large \$400-to-\$500 million Daniel Boone Fund that Prisma had recently sold to KRS. After the acquisition by KKR of Prisma, KKR/Prisma knew that this custom-designed Daniel Boone Fund was an extraordinarily risky fund of hedge funds vehicle, and that it was illiquid, opaque, and unsuitable for continued holding by a pension fund in the particular situation of KRS, which was badly underfunded and facing accelerating retirements, increasing liquidity needs and fewer and fewer new members.

73. By 2015-2016 many institutional investors in funds of hedge funds had grown angry over excessive and hidden fees, poor investment returns and/or large losses. As lock up periods expired and the toxic reputation of these exotic, opaque, secretive, high-fee/high-risk vehicles spread, the fund of hedge funds industry contracted. Assets under management, the industry's life blood, declined, and the business of the industry underwent a severe contraction.

74. As the Daniel Boone Fund began to lose millions in 2015-2016, KKR/Prisma, Roberts, Kravis, Reddy and Cook helped to arrange for a KKR/Prisma Executive to work inside KRS while still being paid by KKR/Prisma. Reddy and KKR/Prisma referred to this arrangement as a "partnership." Subsequently, while Cook and Peden and the KKR/Prisma executive were working inside KRS, KKR/Prisma sold \$300 million more in Black Box vehicles to KRS despite that KRS was then selling off over \$800 million in other hedge funds because of poor performance, losses, and excessive fees and the KKR/Prisma Black Box was the worst performing of the three. This very large sale to KRS was a significant benefit to KKR/Prisma, which was then suffering outflows due to customer dissatisfaction over poor results and excessive fees.

75. KKR/Prisma needed new hedge fund business in 2015-2016 as the growth of its business began to slow and its profits suffered. PAAMCO (whose fund of hedge fund business was even more dependent on public pension plans), was also facing the adverse impact of the dramatically shrinking fund of hedge funds market. So, in 2016 PAAMCO and KKR/Prisma began to discuss a strategic

transaction, which would be negotiated and approved by Kravis, Roberts, Reddy and Buchan, and by which they would combine the two fund of hedge fund businesses in hopes of surviving the declining market.

76. The new KKR/Prisma and PAAMCO partnership was announced in February 2017 as one of the largest hedge fund sellers in the world:

KKR/Prisma and PAAMCO will combine to form a new firm, PAAMCO Prisma Holdings, which will have over \$30 billion in assets.

The combined business will be majority employee-owned with employees of PAAMCO and KKR Prisma owning 60.1% of the combined business and KKR retaining a 39.9% ownership stake as a long-term strategic partner.

The combined business will be jointly run by Jane Buchan, co-Founder and CEO of PAAMCO, and Girish Reddy, co-Founder of KKR Prisma and Head of KKR Hedge Funds.

The transaction will...create one of the largest firms in the liquid alternatives industry...

77. When Reddy was asked why KKR/Prisma and PAAMCO were merging their businesses, he said they were moving beyond “funds of funds”:

“As the industry consolidates clients are looking for broader solutions than currently exist – they are looking beyond fund of funds, such as how we can combine products and bring the fees down ... That’s where we see the puck going and we would like to be there and do it from a positive strength.”

In other words, we are leaving the burnt-out embers of the fund of hedge fund industry where we sold toxic waste by the billions to public pension funds (profiting by the hundreds of millions of dollars), and moving on to greener pastures.

Unfortunately, KRS and Kentucky taxpayers must now deal with the ashes left behind. Reddy says the new KKR/Prisma/PAAMCO sales pitch is “We will combine

the alpha engines of each firm and redistribute it.” Whatever that means, it does not communicate a primary focus on prudent fiduciary investing.

78. In acting and failing to act as alleged herein, these Defendants knowingly aided and abetted the breach of duties by Trustees, while participating by committing overt acts, in an ongoing scheme, civil conspiracy, common course of conduct and joint enterprise acting in concert with Trustees and/or each other to commit unlawful acts, including the violation of the mandatory duties imposed on each of them and Trustees by Kentucky law.

**Blackstone, Schwarzman and Hill**

79. Defendant Blackstone Group, L.P. (“Blackstone”) is a large Wall Street financial enterprise that provides asset management and advisory services and sells hedge fund products targeting pension funds as potential customers. Blackstone has yearly revenues of about \$5 billion. It has over \$2 billion in annual net income. It is an extraordinarily profitable business and receives large fees on its hedge fund vehicles regardless of investment performance.

80. Blackstone’s hedge fund division, Blackstone Alternative Asset Management, L.P. (“BAAM”) (“Blackstone” and “BAAM” are collectively referred to as “Blackstone”), is the world’s largest “allocator” to hedge funds, and is a leading manager of institutional funds of hedge funds. It stated that its “Hedge Fund Solutions” investment philosophy “is to protect and grow investors’ assets through both commingled and custom-designed investment strategies designed to deliver compelling risk-adjusted returns and mitigate risk. Diversification, risk

management, due diligence and a focus on downside protection are key tenets of our approach.”

81. Blackstone claims to be a sophisticated and experienced expert in financial matters. It has said that before deciding to invest in a new hedge fund or with a new hedge fund manager, it “conducts extensive due diligence” including a “review of the fund’s manager’s performance ... [and] risk management ... Once initial due diligence procedures are completed and the investment and other professionals are satisfied ... the team will present the potential investment to the relevant Hedge Fund Solutions Investment Committee ... [of] senior managing directors ... and other senior investment personnel. ... Existing hedge fund investments are reviewed and monitored on a regular and continuous basis ... Blackstone Vice Chairman and BAAM CEO, J. Tomilson Hill, ... and other senior members of our Hedge Fund Solutions team meet bi-weekly with Mr. Schwarzman ... to review the group’s business and affairs.”

82. Defendant Stephen A. Schwarzman is the Chairman and Chief Executive Officer of Blackstone and leads the firm’s Management Committee. Schwarzman founded Blackstone and has been involved in all phases of the firm’s development since its founding. Schwarzman rose to prominence at Lehman Brothers, where he was a top executive – a Managing Director. Lehman later collapsed amidst widespread financial fraud and misconduct at the firm. According to Blackstone, it “depends on the efforts, skills, reputations and business contacts of

Schwarzman, and other key senior managing directors, the information and deal flow they generate during the normal course of their activities ... ”

83. Because of Schwarzman’s status as a Founder, Board Chair and CEO of Blackstone, as well as serving as Chair of its Management Committee, Schwarzman was in a position to control and did control the day-to-day operations of Blackstone during the relevant time periods. Through a complex web of private partnerships and trusts, Schwarzman can elect all of Blackstone’s Board of Directors and control all aspects of Blackstone’s corporate structure and operation and has done so – control so absolute that he has “no duty or obligation (fiduciary or otherwise) to give any consideration to any interest of [Blackstone’s unit holders] and will not be subject to any different standards imposed by ... law, rule, or regulation or in equity.” Schwarzman was the responsible corporate officer for the selection, oversight, supervision and training of the top officers and personnel of Blackstone other than himself who were involved in the day-to-day dealings with KRS during the relevant time period.

84. Defendant J. Tomilson Hill is President and Chief Executive Officer of the Hedge Fund Solutions group, Vice Chairman of Blackstone and Chief Executive Officer of BAAM. Hill is responsible for overseeing the day-to-day activities of the group, including investment management, client relationships, product development, marketing operations and administration. Before joining Blackstone, Hill served as Co-Chief Executive Officer of Lehman Brothers, which later collapsed amidst widespread financial fraud and misconduct.



85. Blackstone targeted KRS as a troubled public pension fund making it a potential customer for the exotic investment vehicles it created and sold. It spotted KRS' underfunded Funds and, because of its sophistication, Blackstone realized the Trustees and Officers were dealing with a much more serious internal financial and demographic situation than was publicly known. Blackstone custom-designed "Black Box" fund of fund vehicles and indicated to Trustees and Officers that it would produce the kind of high investment returns, with downside protection and safe diversification, that Trustees and Officers were seeking to make up for past losses and cover up their malfeasance. Blackstone nicknamed this vehicle the "Henry Clay Fund."

86. Blackstone, Schwarzman and Hill knew that this custom-designed Henry Clay Fund was an extraordinarily risky fund of hedge funds vehicle, and that it was illiquid, opaque, and unsuitable for a pension fund like KRS. KRS was badly underfunded and facing accelerating numbers of member retirements, resulting in increasing liquidity needs and fewer new members.

87. The Henry Clay Fund provided exceptionally large fees for Blackstone. The amount of the fees could not be calculated and were not disclosed to KRS, many hidden in an impenetrable spider web of fees, spun together by Blackstone for its benefit.

88. Hedge Fund Sellers themselves and the "absolute return assets" or "absolute return strategies," *i.e.*, fund of hedge funds they sold KRS were discussed in KRS' Annual Reports, each of the Hedge Fund Sellers reviewed and was aware of

the contents of the KRS Annual Reports. They knew that the information therein regarding the KRS “Absolute Return” assets/strategies, *i.e.*, the Black Boxes, was incomplete, inaccurate, false, and misleading. Hedge Fund Sellers also knew if the true nature and risks of these high-risk/high-fee vehicles were disclosed in the KRS Annual Reports, an uproar would have resulted and the unsuitable “investments” could have been terminated, costing the Hedge Fund Sellers millions and millions of dollars a year in fees. Hedge Fund Sellers let the deception continue because it served their selfish economic purposes.

89. In acting and failing to act as alleged herein, these Defendants knowingly aided and abetted the breach of duties by Trustees, while participating by committing overt acts, in an ongoing scheme, civil conspiracy, common course of conduct and joint enterprise acting in concert with Trustees and/or each other to commit unlawful acts, including the violation of the mandatory duties imposed on each of them and Trustees by Kentucky law.

#### **PAAMCO and Buchan**

90. Pacific Alternative Asset Management Company, LLC (“PAAMCO”) is located in Irvine, California and operates world-wide. PAAMCO sells investment products including hedge funds and funds of hedge funds and describes itself as:

“... a leading institutional investment firm dedicated to offering alternative investment solutions to the world’s preeminent investors. Since its founding in 2000, PAAMCO has focused on investing on behalf of its clients while striving to raise the standard for industry-wide best practices. With a global footprint that extends across North America, South America, Europe and Asia, PAAMCO’s clients include large public and private pension funds, sovereign wealth funds, foundations, endowments, insurance companies and financial institutions. The firm is known for its

complete Alpha approach to hedge fund investing which focuses on ... controlling costs and protecting client assets.”

In 2017, PAAMCO was acquired by KKR/Prisma as detailed above.

91. During 2009-2011 PAAMCO was one of the largest, fastest growing and most profitable hedge fund sellers in the United States with several billion dollars of assets under management. PAAMCO claimed special expertise in designing and managing hedge funds, especially funds of hedge funds designed for public pension plans.

92. Defendant Jane Buchan was a co-founder and CEO of PAAMCO. Materials approved by Buchan and PAAMCO describe her as the Chief Executive Officer of PAAMCO, and “[a]s CEO, Jane is responsible for overall business strategy and firm direction.” Buchan was the dominant Executive and personality at PAAMCO, a closely held private company, and was hands-on involved in all aspects of its funds of hedge fund business which specifically targeted public pension plans. She personally oversaw and directed the sale of the PAAMCO Black Box fund of hedge funds to KRS.

93. Because of Buchan’s status as a co-founder, Board member, and CEO of PAAMCO, as well as serving Chair of its Management Committee, Buchan was in a position to control and did control the day-to-day operations of PAAMCO during the relevant time periods. Buchan could, with a few co-founders, elect all of the Directors of PAAMCO, appoint all officers and control all aspects of PAAMCO’s corporate structure and operation, and she did so. Buchan was the responsible corporate officer for the selection, oversight, supervision and training of the top

officers and personnel of PAAMCO other than herself who were involved in the day-to-day dealings with KRS during the relevant time period.

94. PAAMCO targeted KRS as a troubled public pension fund as a potential customer for the exotic investment vehicles it created and sold, knowing the trustees and officers were dealing with a much more serious financial and actuarial situation than was publicly known. PAAMCO custom-designed a “Black Box” fund of hedge funds vehicle and indicated to Trustees and Officers that it would produce the kind of high investment returns, with downside protection and safe diversification, that Trustees and Officers were seeking to make up for past losses and cover up their malfeasance. PAAMCO nicknamed this vehicle the “Colonels Fund.”

95. PAAMCO and Buchan knew that this custom-designed Colonels Fund was an extraordinarily risky fund of hedge funds vehicle, and that it was illiquid, opaque, and unsuitable for a pension fund like KRS. KRS was badly underfunded and facing accelerating numbers of member retirements, resulting in increasing liquidity needs and fewer and fewer new members.

96. For years, PAAMCO and Buchan have held themselves out to be paragons of virtue in the hedge fund industry, a leading example of adherence to the highest possible standards of honesty, transparency and ethical behavior in its business practices. In a glowing profile of Buchan in 2014 in the Orange County Register, that Buchan reviewed and approved, it was reported:

Buchan, CEO and co-founder of Pacific Alternative Asset Management Co. (PAAMCO), is one of the most powerful women in global finance, a luminary in the complex, opaque hedge fund universe.

With satellite offices in Singapore and London, Buchan's fund-of-funds is a manager and adviser for some of the world's biggest pension plans, endowments and sovereign wealth funds, helping them to invest some \$15.7 billion into hedge funds.

#### WORKING FOR RETIREES

...

From the outset, PAAMCO focused on institutions. Unlike many funds-of-funds, Buchan said, "we don't do high-net worth individuals. There's nothing wrong with making rich people richer, but that is not the ethos of this company."

Plus, there's the intellectual challenge: a single wealthy investor might have as much as a billion or so dollars to invest in hedge funds. Pension plans juggle many billions.

"We build big portfolios for very sophisticated clients," Buchan said. "We like working with very large pools of capital and very compelling problems."

While a few institutions set aside "affirmative investment" money targeting, in part, female or minority managers, Buchan said PAAMCO has never sought business through diversity mandates.

"This firm has succeeded by going toe to toe with the top firms," she said. "I compete against both men and women. I'm not interested in being the tallest dwarf. I don't care to get extra points for being green, purple, short, thin or fat."

97. According to Buchan, she is asked to speak all over the world because "[w]e are known throughout the world for promoting fiduciary standards in hedge fund investing." Buchan and PAAMCO helped found, and Buchan is a director of, the International Hedge Fund Standards Board,<sup>13</sup> the standard-setting organization for the hedge fund industry, which claims to promote "transparency, integrity and

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<sup>13</sup> In light of recent events disgracing the fund of hedge fund industry Buchan's Board is now called "Standards Board for Alternative Investments."

good governance” in the way the hedge fund industry operates.

98. PAAMCO was founded in 2000 by Buchan and a few others with secret financial support from ultra-wealthy hedge fund mogul S. Donald Sussman of Greenwich, Connecticut. Sussman had a background Buchan wanted to conceal from potential investors, customers and regulators, as he had been convicted of dishonest behavior in connection with the investment of fiduciary monies. Buchan and Sussman created fake documents to disguise Sussman’s large ownership stake in PAAMCO as a loan, because Buchan and the other founders believed they could hide Mr. Sussman’s background from investors and regulators. “A Hedge Fund Controlled by Women, So It Claimed,” published by The New York Times on October 18, 2010, reported that the “loan” terms were extraordinary. The real deal was a \$2 million investment by Sussman for 40% ownership of PAAMCO, with Buchan and the parties putting up only \$40,000 total. Sussman was paid the greater of either 10% annual interest or 40% of the profit of PAAMCO. From 2003-2007, Sussman secretly collected his share of the profits, \$55 million. As PAAMCO continued to make these huge profits, Buchan decided to evade and dishonor the secret commitment to Sussman. As a result, Sussman sued Buchan and her co-founders of PAAMCO for fraud and breaches of fiduciary duty, exposed their dishonesty and won the case on summary judgment. Buchan and her PAAMCO co-founders did not appeal. To further conceal Sussman’s ownership of PAAMCO, Sussman and Defendant Buchan used offshore shell companies called Paloma Partners/Franklin Realty Co. to hold his PAAMCO interest.

99. In sworn testimony, one PAAMCO co-founder admitted there were “two important factors” why Sussman’s ownership and control of PAAMCO was hidden: “The first was the potential impact of disclosing Mr. Sussman’s involvement” in a governmental filing and “the second was our potential to have status as a majority female-owned entity,” which could lead to “engagement as an investor and manager to an extent that otherwise wouldn’t be the case.”

100. Buchan not only concealed Sussman’s ownership of PAAMCO to deceive customers and regulators but also to falsely present the picture of a female-controlled enterprise, which gave PAAMCO an edge in competing for public pension fund business. Buchan used PAAMCO’s purported “female majority owned” to improperly gain a competitive advantage, and to attract pension funds.

101. The Judge in Sussman’s case noted that the disguised ownership arrangements with Sussman “may have been designed to mislead a number of observers, from the tax authorities to the SEC to entities wishing to invest in women-owned businesses.” As a result of these findings of fiduciary dishonesty by the PAAMCO founders, public pension funds withdrew millions of dollars of their trust fund assets from the PAAMCO managed or created hedge funds. These events occurred shortly before PAAMCO sold the Colonels Fund to KRS.

#### **INVESTMENT, ACTUARIAL AND FIDUCIARY ADVISORS AND ANNUAL REPORT CERTIFIER DEFENDANTS**

##### **Investment Advisors - R.V. Kuhns, Voytko, Gratsinger**

102. Defendant R.V. Kuhns & Associates, Inc., a/k/a/ RVK, Inc. (“RVK”) became KRS’ investment advisor following the termination of the previous advisor

as a result of KRS' \$4.4 billion in investment losses in 2008-2009. RVK holds itself out as having great experience and expertise in investments. It describes itself as: "One of the largest fully independent ... consulting firms in the US, [which] provides world-class investment advice to institutional investors, including defined benefit and defined contribution pension plans ... RVK also states it provides "unbiased general investing consulting services ... a team of dedicated consultants with significant experience in the financial field, including investment advising, investment management and actuarial advisory services."

103. Defendant Jim Voytko was the President and Principal of RVK until 2012. Voytko and his successor, Defendant Rebecca Gratsinger, were each personally involved in the KRS account and each signed one or more of the false and misleading letters and reports contained in KRS Annual Reports detailed herein. KRS was an important source of fees for RVK and an account that was crucial to Voytko and Gratsinger's personal success, compensation and position in the firm. RVK, Voytko, and Gratsinger very much wanted to keep KRS as a client. RVK's business model depended on representing a large number of public pension funds, charging each, including KRS, over \$500,000 each year. The pension funds were, in effect, an "annuity client." RVK's business model depended on keeping clients. These Defendants chose to go along, participate and approve, and then pocket their large fees each year.

104. Rebecca Gratsinger, became the CEO of RVK in 2012, and she took over the KRS account.



105. RVK, Voytko and Gratsinger were intimately involved in the affairs of KRS and its Funds. They had unlimited access to all KRS internal data and investments detail, and were aware of KRS' true financial and actuarial condition. RVK prepared the analysis ("the RVK Report") in 2010 which revealed the closing vise that KRS faced between the demographics of its members and beneficiaries and its actuarial situation. RVK advised Trustees and Officers to quickly put \$1.2/1.5 billion in the Black Boxes, even though they were unsuitable investments for KRS. They have also repeatedly made false statements regarding KRS' investing principles, practices, procedures, skills and results in KRS Annual Reports, falsely reassuring members and taxpayers as to the state of Trustees' stewardship.

106. RVK, Voytko, and Gratsinger reviewed and were aware of the contents of the KRS Annual Reports and knew that the information therein was incomplete, false, and misleading that they had a duty to correct these statements. They also knew if the true nature of these high-risk, high-fee vehicles or the over-stated AARIR assumptions and estimates were disclosed in the KRS Annual Reports, an uproar would have resulted, an independent investigation could have ensued and RVK could have been terminated, costing them an important client and threatening their high volume public pension fund client driven business model. RVK, Voytko and Gratsinger let the deception continue because it served their selfish economic purposes to do so.

107. In acting and failing to act as alleged herein, these Defendants knowingly aided and abetted the breach of duties by Trustees, while participating

by committing overt acts, in an ongoing scheme, civil conspiracy, common course of conduct and joint enterprise acting in concert with Trustees and/or each other to commit unlawful acts, including the violation of the mandatory duties imposed on each of them and Trustees by Kentucky law.

**Actuarial Advisor – Cavanaugh Macdonald Consulting**

108. Defendant Cavanaugh Macdonald Consulting, LLC (“Cavanaugh Macdonald”), a Georgia limited liability company, represented that it had superior skill, experience and expertise in public pension fund actuarial matters and had the capability to independently and accurately determine the assumptions and estimates necessary to properly oversee and operate a public pension fund.

“We are innovative and independent, seasoned ... That’s the Cavanaugh Macdonald promise: providing you the advice to help your benefit plans thrive. We are leaders in the public sector consulting community, providing thoughtful and innovative solutions that enable public sector benefit plans to thrive. We provide impartial advice and maintain our independence from political and other outside influences, and these strengths ... and make us the leading public sector actuarial consultants in the country.”

109. Cavanaugh Macdonald provided expert actuarial services to KRS for many years. It supplied a certification each year for KRS’ actuarial estimates and assumptions as contained in the KRS Annual Reports. This included KRS’ AARIR and the underlying actuarial assumptions and estimates that went into calculating the actuarial liabilities owed by KRS.

110. Defendants Thomas J. Cavanaugh (CEO), Todd B. Green (Principal) and Alisa Bennett (Principal) were executives and principals at Cavanaugh Macdonald and were in charge of the KRS account. They signed one or more of the

false Cavanaugh Macdonald certifications, opinions and reports that were contained in KRS Annual Reports.

111. KRS was an important client and source of fees for Cavanaugh Macdonald. Cavanaugh Macdonald's business model depended on representing many public pension funds, charging each, including KRS, over \$500,000 each year. These funds were essentially "annuity clients." It was important in this business model not to lose clients, particularly by matters within its own control. Cavanaugh Macdonald wanted to keep KRS as a client, and was willing to overlook uncomfortable and inconvenient realities to do so.

112. The KRS account was of considerable personal and financial importance to Cavanaugh, Green and Bennett and their status, compensation and position in the firm depended upon it.

113. Cavanaugh Macdonald each reviewed and were aware of the contents of the KRS Annual Reports and knew that the information therein was incomplete, false and misleading. They also knew if the true nature and risks of the false actuarial assumptions and estimates were disclosed in the KRS Annual Reports, KRS' publicly reported funding deficit would have skyrocketed, an uproar would follow, investigations could have ensued, and they could have been terminated. Cavanaugh Macdonald would lose an important client and their high-volume public pension fund client-driven business model would be threatened. Allowing the deception to continue served the economic interest of Cavanaugh Macdonald who chose inaction to benefit their own economic self-interest.

114. In acting and failing to act as alleged herein, these Defendants knowingly aided and abetted the breach of duties by Trustees, while participating by committing overt acts, in an ongoing scheme, civil conspiracy, common course of conduct and joint enterprise acting in concert with Trustees and/or each other to commit unlawful acts, including the violation of the mandatory duties imposed on each of them and Trustees by Kentucky law.

**Fiduciary Advisor – Ice Miller**

115. Defendant Ice Miller, LLP (“Ice Miller”), is a limited liability partnership law firm that has served as Fiduciary Advisor to KRS for many years. Ice Miller has had unrestricted access to KRS records and data and constant participation in and intimate knowledge of KRS’ true finances, demographics and actuarial situation.

116. Ice Miller states that it has extensive expertise and experience in fiduciary matters for pension plan trustees including advising on the purchase of fiduciary insurance, conflicts of interest and investments in fund of hedge fund investments:

“We represent ... public retirement systems ... [as] a talent mosaic with the ability to bring the exact legal skills needed for specific projects; [its] Alternative Investments Group offers a broad range of legal advice and services ... in connection with [public funds’] alternative investment programs; [and] ... since the late 1980s, we have advised these clients in the collective investment of billions of dollars ... Our attorneys have significant experience evaluating, structuring and negotiating alternative investments across the full range of strategies ... Our attorneys are experienced with alternative investments of all sizes ... to the largest multi-billion-dollar fund of funds. We also regularly advise our institutional investor clients regarding the protection of their alternative investments.”

117. KRS was an important client and source of fees for Ice Miller. Ice Miller's business model depended on representing many public pension funds, charging each, including KRS, over \$500,000 each year. These funds were essentially "annuity clients." It was important in this business model not to lose clients, particularly by matters within its own control. Ice Miller wanted to keep KRS as a client, and was willing to overlook uncomfortable and inconvenient realities to do so.

118. KRS trustees were authorized by the Kentucky Pension Law to use KRS Funds to purchase fiduciary insurance in order to protect KRS, its Funds and Kentucky taxpayers from fiduciary defalcations by KRS' trustees or officers. KRS is one of the largest economic entities in the Commonwealth. It holds and invests billions of dollars while overseeing the benefits for hundreds of thousands of workers. These pension plans are funded and backstopped by the Commonwealth of Kentucky. These groups were necessarily exposed to hundreds of millions of dollars in damages, harm or loss if the KRS Trustees or Officers failed to comply with their legal duties.

119. Given KRS' deteriorating financial and actuarial condition, its internal dysfunction and mismanagement, and the staff turnover, these risks of loss were magnified. Even though Trustees could have purchased adequate fiduciary insurance with KRS funds, Ice Miller failed as fiduciary advisor to KRS by not advising, encouraging, and directing Trustees and Officers to purchase coverage in

excess of \$300 million, which was clearly needed, instead of the \$5 million in fiduciary insurance coverage that KRS had.

120. Ice Miller has also breached its duties by failing to adequately implement, update and oversee the training and education program for trustees and officers as mandated by Kentucky Pension Law. Trustees who were sold the Black Boxes were inadequately trained in fund of hedge fund vehicles and in how to properly and legally deal with the financial/actuarial vise they were in 2010-2011. Ice Miller has continued to violate its duties to KRS by permitting Cook to serve on the Investment Committee (and at one time to be the Investment Committee Chair) and as a trustee during the time KRS invested hundreds of millions of dollars in Prisma to help KKR/Prisma while a Prisma executive, still paid by Prisma, worked inside KRS, with access to confidential information and the ability to wield influence.

121. Ice Miller reviewed and was aware of the contents of the KRS Annual Reports and knew that the information therein was false and misleading. It knew that, if the true nature of these high-risk, high-fee Black Box vehicles were known and the false and unrealistic actuarial assumptions and estimates were disclosed in the KRS Annual Reports, KRS' publicly reported funding deficits would have skyrocketed, an uproar would follow, and an independent investigation could have occurred. Ice Miller could have been terminated and could have lost an important client, thereby threatening its high-volume public pension fund client-driven business model. Ice Miller chose inaction to benefit its own economic self-interest.

122. In acting and failing to act as alleged herein, this Defendant knowingly aided and abetted the breach of duties by Trustees, while participating by committing overt acts, in an ongoing scheme, civil conspiracy, common course of conduct and joint enterprise acting in concert with Trustees and/or each other to commit unlawful acts, including the violation of the mandatory duties imposed on each of them and Trustees by Kentucky law.

**The Annual Report Certifier – Government Finance Officers Association**

123. Defendant Government Finance Officers Association of the United States and Canada (“GFOA”), organized as an Illinois not-for-profit corporation, is a professional association of state and local finance officers. It states:

“GFOA sponsors award programs designed to encourage sound financial reporting for financial documents including the Comprehensive Annual Financial Report, or CAFR ... The group also awards an award for Excellence in government finance.”

According to GFOA it:

“Established the Certificate of Achievement for Excellence in Financial Reporting Program (CAFR Program) in 1945 to encourage and assist state and local governments to go beyond the minimum requirements of generally accepted accounting principles to prepare comprehensive annual financial reports that evidence the spirit of transparency and full disclosure and then to recognize individual governments that succeed in achieving that goal.”

\* \* \*

“Reports submitted to the CAFR program are reviewed by selected members of the GFOA professional staff and the GFOA Special Review Committee (SRC) which comprises individuals with expertise in public sector financial reporting and includes financial statement preparers, independent auditors, academics and other finance professionals.”

124. According to GFOA, it conducts a very thorough review of any pension trust or plan that applies for a Certificate of Achievement in financial reporting.

The GFOA's review process "typically requires an additional 4 to 6 months." To be considered for the award, KRS supposedly had to submit a very long, detailed, single-spaced application asking for great detail about the Plan's operation, finances, investments and practices, as well as the annual report it sought to have "certified."

125. GFOA's business model depended on selling a large volume of public pension funds memberships/certificates/endorsement and awards and thereby generating revenue. GFOA operates as a commercial enterprise, charging public pension funds fees to have their employees join. The larger the fund the larger the fee. GFOA also charges a size-based fee in return for issuing its Certificate and Achievement awards, in effect taking fees and dues in return for handing out prestigious sounding and looking awards and certificates but doing no real research or investigation, nor any skeptical, detailed, independent review or evaluation.

126. With the approval of GFOA, year after year – for 15-16 years – the KRS Annual Report to members and Kentucky taxpayers prominently displayed a color picture of the "Certificate of Achievement for Excellence in Financial Reporting" award to KRS, right up front and on the same page as the pictures of the trustees, including the GFOA logo. An example follows:





127. The GFOA reviewed and knew the contents of KRS Annual Reports and knew that the information therein was incomplete, inaccurate, false, and misleading. However, the GFOA depends upon the monies it gets for issuing these certifications and advertisements to public pension plans. If it suddenly withdrew or refused to continue giving the annual awards and certification to KRS, that would have raised red flags, pension funds would have shied away from using GFOA which could have threatened GFOA's volume-driven, hand-out-the-certifications-in

return-for-the-money, business model. GFOA chose to continue its awards and false certifications to KRS in order to benefit its own economic self-interest.

128. In acting and failing to act as alleged herein, this Defendant knowingly aided and abetted the breach of duties by Trustees, while participating by committing overt acts, in an ongoing scheme, civil conspiracy, common course of conduct and joint enterprise acting in concert with Trustees and/or each other to commit unlawful acts, including the violation of the mandatory duties imposed on each of them and Trustees by Kentucky law.

#### **IV. DUTIES OF DEFENDANTS TO KRS, ITS FUNDS AND KENTUCKY TAXPAYERS IN OVERSEEING, OPERATING AND DEALING WITH KRS**

##### **A. KENTUCKY PENSION, TRUST AND OTHER LAWS**

129. Each Defendant had a duty to comply with Kentucky law, including the Kentucky Pension Law, Kentucky Trust Law, as well as the common law duties to act with due care and in good faith with respect to KRS. “A person injured by the violation of any statute may recover from the offender such damages as be sustained by reason of the violation,” Ky. Rev. Stat. §446.070. KRS and Kentucky taxpayers are entitled to avail themselves of the rights under Ky. Rev. Stat. §446.070.

130. In order to protect KRS, its Funds, their members and beneficiaries and Kentucky taxpayers, the Kentucky Legislature imposed stringent statutory duties on persons who became involved with KRS and its Plans. Each Trustee of KERS was required to swear to the following oath:

Each member of the board of trustees shall, within ten (10) days after his appointment or election, take an oath that will support the Constitution of the United States and the Constitution of Kentucky, that he will diligently and honestly administer the affairs of the board, and that he will not knowingly violate or willingly permit to be violated any provisions of the law applicable to the retirement system.

The duties owed by each of Defendants was owed to KRS, its Funds, members and beneficiaries, and the Commonwealth of Kentucky and its taxpayers.

131. The Kentucky Pension Law establishes three pension “systems.” The statute creating the Kentucky Employees Retirement System (“KERS”), the oldest of the three systems, provides as follows:

**61.515 Retirement systems established - Fund created:**

There is hereby created and established:

- (1) A retirement system for employees to be known as the “Kentucky Employees Retirement System . . . which . . . shall have the powers and privileges of a corporation; and
- (2) A fund, called the “Kentucky Employees Retirement Fund” which shall consist of all the assets of the system [and] all assets received in the fund shall be deemed trust funds to be held and applied solely as provided in [Ky. Rev. Stat. §§] 61.510 to 61.705.

There are separate, quite similar, statutes creating the “County Employees Retirement System” (“CERS”), Ky. Rev. St. § 78.790, and “State Police Retirement System” (“SPRS”), Ky. Rev. Stat. § 16.642, and their respective funds. All three systems are governed by the same Board, and managed by staff retained by that Board.

**61.645 Board of Trustees – Powers – Members –Other Duties – Annual financial report – Trustees education program – Information made available to public**

- (1) The County Employees Retirements System, Kentucky Employees Retirement System and State Police Retirement System shall be administered by the board of Trustees of the Kentucky Retirement Systems...

\* \* \*

- (2) The board is hereby granted the powers and privileges of a corporation, including but not limited to the following powers:

- (a) To sue and be sued in its corporate name;
- (f) To purchase fiduciary liability insurance;

\* \* \*

- (3) (a) A trustee shall discharge his duties as a trustee . . .

- 1. In good faith;
- 2. On an informed basis; and
- 3. In a manner he honestly believes to be in the best interest of the Kentucky Retirement Systems

- (b) A trustee discharges his duties on an informed basis if, when he makes an inquiry into the business and affairs of the Kentucky Retirement Systems or into a particular action to be taken or decision to be made, he exercises the care an ordinary prudent person in a like position would exercise under similar circumstances.

\* \* \*

- (h). . . a trustee shall strive to administer the retirement system in an efficient and cost-effective manner for the taxpayers of the Commonwealth of Kentucky.

\* \* \*

- (18) The board shall establish a formal trustee education program for all trustees on the board. The program shall include but not be limited to the following:

- (a) A required orientation program for all new trustees elected or appointed to the board[, which] shall include training on:

\* \* \*

- 2 Investment concepts, policies, and current composition and administration of retirement systems investments;
- 3 Laws, . . . pertaining to the retirement systems and to fiduciaries;
- 4. Actuarial and financial concepts pertaining to the retirement systems.

\* \* \*

- (b) Annual required training for board members on the . . . financing, and investing of the retirement systems...

\* \* \*

- (19) In order to improve public transparency regarding the administration of the systems, the board of trustees shall . . . make available...

\* \* \*

(b) The Comprehensive Annual Financial Report ...

\* \* \*

(m) Information regarding the systems' financial and actuarial condition that is easily understood by the members, retired members, and the public.

#### **61.650 Board trustee of funds – Investment Committee – Standards of conduct**

(1)...

\* \* \*

(c) A trustee, officer, employee, or other fiduciary shall discharge duties with respect to the retirement system:

1. Solely in the interest of the members and beneficiaries;
2. For the exclusive purpose of providing benefits to members and beneficiaries and paying reasonable expenses of administering the system;
3. With the care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose;

\* \* \*

(d) In addition to the standards of conduct prescribed [above], all individuals associated with the investment and management of retirement system assets, whether contracted investment advisors, board members or staff employees, shall adhere to the Code of Ethics and Standards of Professional Conduct, the asset Manager Code of Professional Conduct if the individual is managing retirement system assets, and the Code of Conduct for Members of a Pension Scheme Governing Body if the individual is a board member...

\* \* \*

#### **61.655 Board of trustees – Conflict of interest**

No trustee or employee of the Kentucky Retirement Systems Board shall:

(1) Have any interest, direct or indirect, in the gains or profits of any investment or transaction made by the board . . .

\* \* \*

- (5) Use his or her official position with the retirement system to obtain a financial gain or benefit or advantage for himself or herself or a family member;
- (6) Use confidential information acquired during his or her tenure with the retirement system to further his or her own economic interests or that of another person; or

- (7) Hold outside employment with or accept compensation from any person or business with which he or she has involvement as part of his or her official position with the retirement system....

132. In addition to the duties imposed by the Kentucky Pension Law, the members of the KRS Board of Trustees are trustees (*see* Ky. Rev. Stat. Chapter 386B, Uniform Trust Code) and the KRS Funds under their control are “Trust Funds.” Ky. Rev. Stat. §386B.10-020 provides that “[a] trustee who commits a breach of trust is liable to the beneficiaries affected for ... the amount required to restore the value of the trust property to what they would have been had the breach not occurred.”

133. Under the language of the Kentucky Pension Law, and also (i) because their roles gave them constant access to non-public information of KRS and its Pension Funds; (ii) because they held themselves out to be very sophisticated, highly qualified experts with extensive experience and expertise in their respective fields; (iii) because they knew the KRS trustees were dealing with internal turmoil and staff turnover and new, inexperienced investment staff and investment advisors and would be unusually dependent upon their professed, superior experience, expertise, and sophistication in their respective areas of expertise; and (iv) because in the case of the Hedge Fund Sellers they had discretion to select the downstream Black Box funds and were also acting investment advisors and/or investment managers for KRS, the Hedge Fund Sellers and the Investment, Actuarial and Fiduciary Advisors were all fiduciaries to KRS, its Plans and its members and beneficiaries as well as the taxpayers of Kentucky.

## **B. TRUSTEES' OPERATION AND OVERSIGHT OF THE KRS PENSION FUNDS**

134. Operating and overseeing a pension fund is similar to managing other trusts that hold and invest the money of others. The trustee is obligated to protect and invest that money and must be able to pay out those funds to beneficiaries, on demand or according to some contractual obligation down the road. Pension fund trustees must be well informed regarding, and understand in detail, the true financial condition of the trust, the economic circumstances in which they operate, the changing composition of the beneficiary pool, retiree rates, new hire member rates, salary levels and inflation, longevity of plan beneficiaries, and most importantly how much the trustees can realistically expect to earn on the fund assets they oversee and invest. All of this is needed to meet their duties as prudent fiduciaries including having the required funds available to payout when needed, in the short and longer terms. In other words, they must carefully and realistically match the trust fund's assets and liabilities.

135. Because a public pension plans like KRS involve large numbers of plan members and beneficiaries (over 350,000) entitled to fixed, legally protected benefits totaling billions of dollars, with large amounts of assets (\$15 billion) to be invested over very long periods of time, the "law of large numbers" applies. Even a very small change in any of the key estimates/assumptions – how many members will retire and how long will they live; how many new employees will enter the plan, how much will they be paid, what will their raises look like, what will be their plan contributions, what will the inflation rate be and how much will the plan earn on its

investments – can have a very large dollar impact when spread over the plans and over time.

136. Of all actuarial assumptions, the annual investment return assumption (AARIR) has the greatest impact on the projected long-term financial health of a pension plan. This is because over time, the majority of revenues of a public pension fund come from investment earnings. Even a small change in a plan's investment return assumption – as little as  $\frac{1}{4}$  of 1% – can result in a very large impact, often hundreds of millions of dollars, on a plan's publicly reported funding level. As one commentator has said:

Of all actuarial assumptions, a public pension plan's investment return assumption has the greatest effect on the projected long-term cost of the plan. This is because over time, a majority of revenues of a typical public pension fund come from investment earnings. Even a small change in a plan's investment return assumption can impose a disproportionate impact on the plan's funding level and cost.

137. Because these actuarial estimates/assumptions are essential to accurately determine all the important metrics on which the pension plan depends, these estimates must be realistic and constantly revised as circumstances evolve. Using knowledge of these factors, the competent, trained and prudent trustee must make discerning judgments as to each of the pertinent variables, in good faith, on an informed basis, and after making inquiries and undertaking skeptical evaluations. Only then can the fund, its governmental sponsor and its beneficiaries know how much money the plan will owe and how funded or underfunded it actually is and how much money the government must put into the fund each year (the annual required contribution) to keep the fund at a healthy funding level. In addition, trustees must accurately and realistically estimate the AARIR a fund will



achieve. The amounts the sponsoring political entities are supposed to contribute to the pension funds to keep the pension safe, stable, and adequately funded depends directly on the accuracy of this assumption.

138. Trustees and Officers consistently used, or allowed the use of, outdated, misleading or false estimates and assumptions of the actuarial value of the Trust Funds' actuarial assets and liabilities. For instance, KRS used an assumed 4.5% yearly governmental payroll growth for future years when new government hiring rates were then near zero and even declining, and interest rates were too. Most glaring was the use of 7.75% of AARIR in all years from 2006 through 2015 when the cumulative moving average annual rate of return of the KRS Funds never even came close to that figure in any one year. That is not a mistake or a bad estimate. It is deliberate, willful manipulation to conceal the true financial and actuarial condition and underfunded status of the KRS Plans.

139. Trustees also breached their duties by failing to adequately investigate and evaluate on an ongoing basis the proper levels of fiduciary liability insurance that should be purchased to protect KRS and the Commonwealth for damages that they could suffer if the trustees or officers violated their fiduciary trustee duties. The KRS Board only has \$5 million in coverage of fiduciary liability insurance coverage, a completely inadequate amount to protect KRS and its funds and Kentucky taxpayers. Given the size of the KRS Trust funds, the ongoing underfunding funding levels and the strict legal duties of trustees and officers, the fiduciary insurance levels should have been at least \$300 million.

140. Under the Kentucky Pension Law, Trustees were required to undergo initial and ongoing training on “actuarial and financial concepts pertaining to the retirement system” and the “financing and investing of retirement systems.” Trustees and Ice Miller never adequately implemented the mandated education program; they did not in good faith pursue the training, continuing education program or test over time the trustees’ competence in these very complex and ever-evolving financial matters and products or their progress in learning about or understanding them.

141. This program was especially important in 2009-2010 given the staff turmoil that plagued KRS and deprived Trustees of experienced staff support. As a result, the Board did not have adequate training, continuing education or expertise to deal with the difficult and complex task presented by the financial and actuarial situation with which they were faced, and they recklessly allowed themselves to be taken advantage of by sophisticated Hedge Fund Sellers, thereby abdicating their mandatory duties.

142. The Code of Conduct for Members of a “Pension Scheme Governing Body,” which is incorporated into the Kentucky Pension Law and sets forth in great detail the conduct required of fiduciary trustees, provides:

**Preamble**

The conduct of those who govern **pension schemes** significantly impacts the lives of millions of people around the world who are dependent on pensions for their retirement income. Consequently, it is critical that **pension plans**, also known as systems, schemes, or funds, are overseen by a strong, well-functioning **governing body** in accordance with fundamental ethical principles of honesty, integrity, independence, fairness, openness, and competence.

\* \* \*

This *Code of Conduct for Members of Pension Scheme Governing Body* (the Code) represents best practice for members of the pension governing body when complying with their duties to the pension scheme. Whether public or private, each pension scheme board that adopts the code will demonstrate its commitment to servicing the best interest of **participants** and **beneficiaries**.

The code provides guidance to those individuals overseeing the management of the scheme regarding their individual duties and responsibilities.

### **Act with skill, competence and diligence.**

Skill and diligence require trustees to be knowledgeable about the matters and duties with which they have been entrusted. Ignorance of a situation or an improper course of action on matters for which the trustee is responsible or should at least be aware is a violation of this code. Improper or ill-advised decisions can be costly to the pension scheme and detrimental to the scheme's participants and beneficiaries. Prior to taking action on behalf of the scheme, effective trustees and/or their designees analyze the potential investment opportunities and act only after undertaking due diligence to ensure they have sufficient knowledge about specific investments or strategies.

Effective trustees will have knowledge and understanding of

- Trust and pension laws.
- Pension scheme funding and liabilities.
- The policies of the scheme.
- The strategies in which the scheme is investing.
- Investment research and will consider the assumptions used – such as risks, inflation, and rates of return – as well as the thoroughness of the analysis performed, the timeliness and completeness of the information, and the objectivity and independence of the source.
- The basic structure and function of the selected investments and securities in which the scheme invests.
- How investments and securities are traded, their liquidity, and any other risks ...

Certain types of investments, such as hedge funds, private equity, or more sophisticated derivative instruments, necessitate more thorough investigation and understanding than do fundamental investments, such as straightforward and transparent equity, fixed-income, or mutual fund products. Trustees may seek appropriate expert or professional guidance if they believe themselves lacking the expertise necessary to make an informed decision.

\* \* \*

**Take actions that are consistent with the established mission of the scheme and the policies that support that mission.**

Effective trustees develop and implement comprehensive written investment policies that set forth the mission, beliefs, and strategic investment plans that guide the investment decisions of the scheme (the “policies”).

- Draft written policies that include a discussion of risk tolerances, return, objectives, liquidity requirements, liabilities, tax considerations, and any legal, regulatory, or other unique circumstances.
- Review and approve the scheme’s investment policies as necessary, but at least annually, to ensure that the policies remain current.
- Only take investment actions that are consistent with the stated objectives and constraints of these established scheme policies.
- Establish policy frameworks within which to allocate risk for both asset mix policy risk and active risk as well as frameworks within which to monitor performance of the asset mix policies and the risk of the overall pension fund.

**Review on a regular basis the efficiency and effectiveness of the scheme’s success in meeting its goals, including assessing the performance and actions of scheme service providers, such as investment managers, consultants, and actuaries.**

Effective trustees have knowledge and understanding to critically review and verify the performance of the scheme’s investment managers.

- Ensure that the investment entity managing scheme assets employs qualified staff and sufficient human and technological resources to thoroughly investigate, analyze, implement, and monitor investment decisions and actions.

- Ensure that investment managers and consultants retained by the scheme adopt and comply with adequate compliance and professional standards.
- Ensure that the pension scheme has in place proper monitoring and control procedures for investment managers.
- Review investment manager performance assessments relative to the scheme's investment policy statement on a regular basis, generally quarterly but at least annually.

**Communicate with participants, beneficiaries, and supervisory authorities in a timely, accurate, and transparent manner.**

Full and fair disclosure of relevant information is a fundamental ethical principle of capital markets and the investment services industry. Developing and maintaining clear, timely, and thorough communication practices is critical to providing high-quality financial services to scheme participants and beneficiaries.

Trustees have a responsibility to

- Ensure that the information they provide to scheme participants and beneficiaries is accurate, pertinent, and complete.
- Not misrepresent any aspect of their services or activities in any communications, including oral representations, electronic communications, or written materials (whether publicly disseminated or not).

\* \* \*

Among other disclosures, trustees have a duty to present performance information that is a fair representation of the scheme's investment record and that includes all relevant factors. Trustees have a responsibility to comply with the scheme's disclosure policies by submitting any requested information in a timely manner. To be effective, disclosures of information must be made in plain language and in a manner designed to effectively communicate the information. (emphasis added).

143. Trustees and Officers willfully or recklessly violated their duties to KRS and its Funds and the taxpayers of Kentucky and did not act in good faith or in what they honestly believed was in the best interests of KRS, and its Funds when they failed to: (i) adequately safeguard the trust funds under their control; (ii) procure adequate fiduciary insurance; (iii) invest the trust assets prudently, (iv)

avoid excessive and/or unreasonable fees and expenses; (v) use realistic estimates and assumptions regarding the actuarial condition and future investment returns of the funds; (vi) adequately match the assets and liability of the funds; or (vii) make truthful, complete, accurate disclosure of, or a fair presentation of, the true financial and actuarial condition the KRS Funds and Plans as is detailed in this Complaint.

### **C. HEDGE FUND SELLERS' DUTIES TO KRS**

144. The Kentucky Pension Law requires that all individuals associated with the investments and management of KRS assets, including investment advisors and managers like the Hedge Fund Sellers and RVK, adhere to the Chartered Financial Analyst Institute (“CFA”) Code Ethics, Standards of Professional Conduct, and the Asset Manager Code of Professional Conduct, which codes express in detail the conduct required of fiduciary advisors and managers. Hedge Fund Sellers and RVK did not do so.

145. The CFA describes itself as follows:

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment professional globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public’s trust in financial markets and in the investment profession. Since their creation in 1960s, the Code and Standards have ... served as a model for measuring the ethics of Investment professionals ... regardless ... or local laws and regulation.

146. The CFA “Code of Ethics” provides persons subject to its code must:

1. Act with integrity, competence, diligence, respect and in an ethical manner with ... clients ...
2. Place ... the interests of clients above their own personal interests.

3. Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions ...

147. In addition, CFA prescribes “Standards of Professional Conduct” for persons subject to the Code:

- A. Knowledge of the Law ...** must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct). In the event of conflict, [they] must comply with the more strict law, rule or regulation.
- B. Independence and Objectivity ...** must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities.
- C. Misrepresentation ...** must not knowingly make any misrepresentations relating to investment analysis recommendations, actions or other professional activities.
- D. Misconduct ...** must not engage in any professional conduct involving dishonesty, fraud or deceit or commit any act that reflects adversely on their professional regulation, integrity or competence.

148. In addition, the CFA Code of Ethics sets forth “Duties to Clients,” providing that persons subject to the code:

- A. Loyalty, Prudence, and Care ...** have a duty to loyalty to the clients and must act with reasonable care and exercise prudent judgment [and] must act for the benefit of their clients and place their clients’ interests before ... their own interests.
- B. Fair Dealing ...** must deal fairly and objectively with all clients when providing investment analysis and making investment recommendations, taking investment action or engaging in other professional activities.

149. The CFA Code of Ethics also commands that persons subject to the code must:

- a. Make a reasonable inquiry into a client’s or prospective client’s investment experience, risk and return objectives recommendation or taking investment action and must reassess and update this information regularly.

- b. Determine that an investment is suitable to the client's objectives, mandates, and constraints before making an investment recommendation or taking investment action.
- c. Judge the suitability of investments in the context of the client's total portfolio.

150. The Code of Ethics also requires that persons subject to it must:

- 1. Exercise diligence, independence and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
- 2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

151. The CFA Institute Asset Manager Code outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients.

## **1. GENERAL PRINCIPLES OF CONDUCT**

Managers have the following responsibilities to their clients.  
Managers must:

- 1. Act in a professional and ethical manner at all times.
- 2. Act for the benefit of clients.
- 3. Act with independence and objectivity.
- 4. Act with skill, competence, and diligence.

\* \* \*

## **2. ASSET MANAGER CODE**

### **A. LOYALTY TO CLIENTS**

- 1. Place client interests before their own.

\* \* \*

### **B. INVESTMENT PROCESS AND ACTIONS**

Managers must:

- 1. Use reasonable care and prudent judgment when managing client assets.

\* \* \*

- 3. Deal fairly and objectively with all clients when providing investment information making investment recommendations or taking investment action.



4. Have a reasonable and adequate basis for investment decisions.

\* \* \*

6. When managing separate accounts and before providing investment advice or taking investment action on behalf of the client.
  - a. Evaluate and understand the client's investment objectives tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances consideration legal or regulatory constraints, etc.) and any other relevant information that would affect investment policy.
  - b. Determine that an investment is suitable to a client's financial situation.

152. In addition to not complying with the duties and standards of conduct set forth in the CFA Codes above, each of the Hedge Fund Sellers was in a conflict of interest when acting as investment advisors or managers in advising the KRS Trustees on hedge fund investments and acting to manage KRS' investments, while at the same time selling KRS, or continuing the placement of, their own custom-designed high-fee, Black Box fund of hedge funds products. The Hedge Fund Sellers, as sophisticated financial professionals recommending investment strategies to KRS while selling their own products, were required to adhere to the highest standards. They had complete discretion to pick the sub-funds in each Black Box, and were the only entity able to exercise any management over them. In addition, the KRS Funds were going to be "locked up" under the Hedge Fund Sellers' control for years. Hedge Fund Sellers had a duty to only recommend those specific investments or overall investment strategies that were suitable for KRS given its particular circumstances, having an "adequate and reasonable basis" for any recommendation made, including an obligation to investigate and obtain adequate

information about the Funds' financial and actuarial condition and the investment recommended. And because of their superior knowledge and expertise and their knowledge of the dependence of the understaffed KRS on them and because they had discretion to select the downstream Black Box Funds, and because monies placed in the Black Boxes could not be withdrawn at will – they owed fiduciary duties as well. They violated all these duties as detailed in this Complaint.

**D. DUTIES OF INVESTMENT, ACTUARIAL AND FIDUCIARY ADVISORS  
AND ANNUAL REPORT CERTIFIER TO KRS**

153. The Investment Advisor Actuarial Advisor, Fiduciary Advisor and the Annual Report Certifier each owed KRS and its Funds and Plans fiduciary duties as well as duties of due care and diligence, and the duty to assure that KRS trustees and officers comply with the Kentucky Pension Law and the other statutes enacted to protect KRS, its members and beneficiaries and Kentucky taxpayers. The Actuarial Advisor, RVK, was also subject to the CFA Code of Ethics, Standards of Professional Conduct, and the CFA Asset Manager Code of Professional Conduct and thus owed the same duties as the Hedge Fund Sellers as alleged above, and also failed to comply with those duties, as detailed in this Complaint. In light of Ice Miller's professed expertise, its duties included overseeing and monitoring the compliance with fiduciary standards by trustees and officers, and by all professionals rendering expert advice and/or services to KRS, and by the sellers of significant investments products to KRS and the Funds.

**V. DEMAND ON THE BOARD TO SUE THEMSELVES AND THEIR ALLEGED CO-ACTORS IS NOT REQUIRED; BUT IF NECESSARY, DEMAND IS EXCUSED AS FUTILE IN THIS DERIVATIVE ACTION; DEMAND ON THE ATTORNEY GENERAL TO BRING TAXPAYER CLAIMS, WHILE NOT NECESSARY, WAS MADE AND HAS BEEN DECLINED**

154. This is a derivative action on behalf of, and for the benefit of, KRS and its Funds and Plans, and a taxpayer action for the benefit of the Commonwealth brought by members of KRS Pension Plans for breach of trusteeship, fiduciary, and statutory duties including aiding, abetting, and participating in concerted action *i.e.*, a common course of conduct, or a civil conspiracy. The action is brought to redress injuries suffered and to be suffered by KRS and the Commonwealth as a result of the breaches of duties and misconduct by Defendants.

155. KRS is named as a nominal defendant solely in a derivative capacity. This is not a collusive action to confer jurisdiction on this court that it would not otherwise have. Plaintiffs are members of the KRS Plans, and were at the time of one or more of the breaches of duties complained of. Plaintiffs will adequately and fairly represent the interest of KRS, its Funds and its members in enforcing and prosecuting their rights. Prosecution of this action, by private counsel independent of the current Board, is in the best interest of KRS and its members, beneficiaries and the Commonwealth of Kentucky.

156. As the members of KRS and as beneficiaries of the KRS Trust Funds, Plaintiffs have standing to assert claims on behalf of KRS and/or its Funds, to affect a recovery that will accrue to the Funds, because trustees have improperly

neglected to bring an action, or actions, against the Defendants. This remedy is available to Plaintiffs in their status as trust beneficiaries regardless of whether a demand on the trustees, or any other person, would have been futile.

157. KRS and its Funds cannot help or protect themselves by bringing this litigation. The legal status of the KRS Board – and its power to act – is itself in doubt, the subject of ongoing lawsuits and disputes between the Attorney General, certain KRS Trustees and the Governor, challenging the legality of the composition of the current Board of Directors of KRS.

158. Plaintiffs have not made a demand on the current KRS Trustees to bring suit asserting the claims set forth herein because pre-suit demand on them is not required under trust law since they have neglected to bring these facially meritorious claims. However, if demand were required as in a “corporate law” derivative suit, it is excused, as it would be a futile act.

159. Plaintiffs have made demand upon the Attorney General of Kentucky to assert the taxpayer claims set forth herein and that demand was declined. Plaintiffs bring their taxpayer action under two alternative theories: first, demand made upon the entity authorized by law to bring the claims was declined; second, in their own right as taxpayers for the Commonwealth of Kentucky, regardless of any action, inaction or inability to act of the Attorney General. For the foregoing reasons, Plaintiffs proceed on the taxpayer claims in *parens patriae*.

160. David Harris, Neil Ramsey, Matt Lattis and John Farris are members of the current Board of Directors of KRS and whose appointment by the Governor

created the litigation which caused the legal status of the KRS Board to be put into dispute and doubt. Susan Smith, Mary Helen Peter, Randy Stevens, Joseph Hardesty and David Rich are also current members of the Board. While these individuals are not named as defendants at this time, they are each disqualified from acting objectively and independently and in good faith with respect to this action. These individuals have (i) allowed Cook to sit on the Board and its Investment Committee even though he has a large economic interest in KKR/Prisma, was with Prisma when it designed and sold the Daniel Boone Fund to KRS (ii) allowed KRS to have a KKR/Prisma Executive inside KRS while being paid by KKR/Prisma and (iii) agreed to have KRS put \$300 million more into the losing Prisma Daniel Boone Fund, while selling off its other hedge funds while hedge funds generally and KKR/Prisma specifically were suffering fund outflows, acting in a way that benefited KKR/Prisma and Cook's economic interests and not solely in the interests of KRS' Funds and their beneficiaries

161. The legal status and power of the current KRS Board to act is in dispute. There is an ongoing legal dispute in this court placing the legal authority of the current Board of Directors to act for KRS in doubt. The Governor, by a June 2017 Executive Order, disbanded the 13 person KRS Board of Trustees and replaced it with a 17-person Board of Directors which included those 13 people and four new Board Members David Harris, Neil Ramsey, William Cook and Mark Lattis, who were also appointed to the Investment Committee. The Attorney General filed suit to block the Executive Order in July. There is also the litigation

over the removal of the prior Chair of the KRS Board and the appointment of his successor. As of this date, these litigations are ongoing. Thus, the current board of directors cannot undertake litigation like this with its own legal status in controversy/doubt and thus neither the current board nor any state officer bring a direct action on their/KRS behalf under these circumstances.

162. Given that the KRS Board cannot bring the claims and the Attorney General has declined to do so, the only way these facially meritorious and potentially valuable claims can be vigorously prosecuted and Defendants held accountable for their misconduct, is by this derivative and taxpayer action (i) prosecuted by experienced, competent, private lawyers on a contingent basis with litigation expenses advanced to assure a vigorous, independent, uncompromised prosecution of these claims (ii) under this court's ongoing supervision where the resolution of this case is under the control of the court; and (iii) where any recovery by settlement or otherwise can be placed under the control of a "special fiduciary" appointed by the court to make sure any net recovery is used – as the Kentucky Pension Law commands – "solely in the interests of the members and beneficiaries" and for the "exclusive purpose of providing benefits to members and beneficiaries" so that any recovery on the taxpayer claims for the Commonwealth is used exclusively to reduce KRS funding deficit and thus benefit taxpayers.

163. As detailed below, all of the current KRS trustees suffer from disabling conflicts of interest and divided loyalties which preclude them from exercising independent good faith judgment required to commence, oversee, and pursue this

type of expensive and contentious litigation. The current Board of Trustees participated in, approved of, and/or permitted some or all of the wrongs alleged herein, concealed or disguised those wrongs, or recklessly and/or negligently disregarded them. There is a substantial likelihood that a majority of the current Board of Trustees could be found liable in this action. Because the Board purchased inadequate Fiduciary Insurance Coverage – \$5 million including defense fees – their own personal assets would be destroyed by any successful litigation. For these and other reasons, the trustees will not authorize KRS to sue themselves or their friends or colleagues personally.

164. In addition, the existing KRS fiduciary insurance policy contains an “insured v. insured” exclusion so that if the trustees sued themselves the insurance coverage would not apply – thus only their own personal assets would be at stake. However, in a derivative suit like this one, that exclusion does not apply and the policy may be realized upon for the benefit of those it was purchased to protect.

165. Trustees could not and will not sue the Hedge Fund Sellers, Investment, Actuarial or Fiduciary Consultants or the Certifier because to do so necessarily would expose their own mistakes and misconduct and show that they are culpable co-actors, schemers, who were pursuing a common course of wrongful conduct with them. To think that under these circumstances Trustees would undertake to sue themselves and the third parties with whom they have worked in concert to deceive is unrealistic in the extreme.

166. A legal claim for damages to a pension fund is an asset of the fund and properly protected and developed can be a very large asset. Like any other significant asset of a pension fund the trustees have a fiduciary duty to protect that asset and to maximize its value. Other public pension funds have recouped billions of dollars through lawsuits against persons and firms which damaged those funds in violation of law – including Wall Street financial houses. Most notable are the suits arising out of the Enron, WorldCom and AOL Time Warner financial collapses by which public pension funds recovered billions of dollars. Many public pension funds have recovered millions more via suits against vendors of investment products and service providers whose negligence or other misconduct damaged them. Yet, trustees here have never retained special outside counsel with expertise in such matters to evaluate the legal basis to pursue such claims and then if valid to pursue them.

167. In 2016, Reuters reported KRS had put \$300 million more into KKR/Prisma's Daniel Boone Fund, making it by far the largest single investment of KRS – almost \$800 million – 5% of its assets:

When Kentucky's public pension put U.S. buyout firm KKR & Co., L.P. in charge of its hedge fund investments ... its board expected the deal to save money and boost its return.

\* \* \*

For the Wall Street firm, the deal paid off. KKR Prisma, increased by nearly half the amount of money it managed on Kentucky's behalf and its fee income rose by at least a quarter, according to KKR Prisma documents seen by Reuters ... Kentucky, so far, has come up short.

\* \* \*

What [made] KKR Prisma ... the top manager of about \$1.65 billion in Kentucky's hedge fund investments, was an offer to let an executive work for two weeks per month out of Kentucky's Frankfort office overseeing the portfolio.



\* \* \*

It was “like having a free staff member,” David Peden, who was the pension fund’s chief investment officer at the time ... He said KKR approached him after it learned he could not find a qualified candidate to run hedge fund investments ...

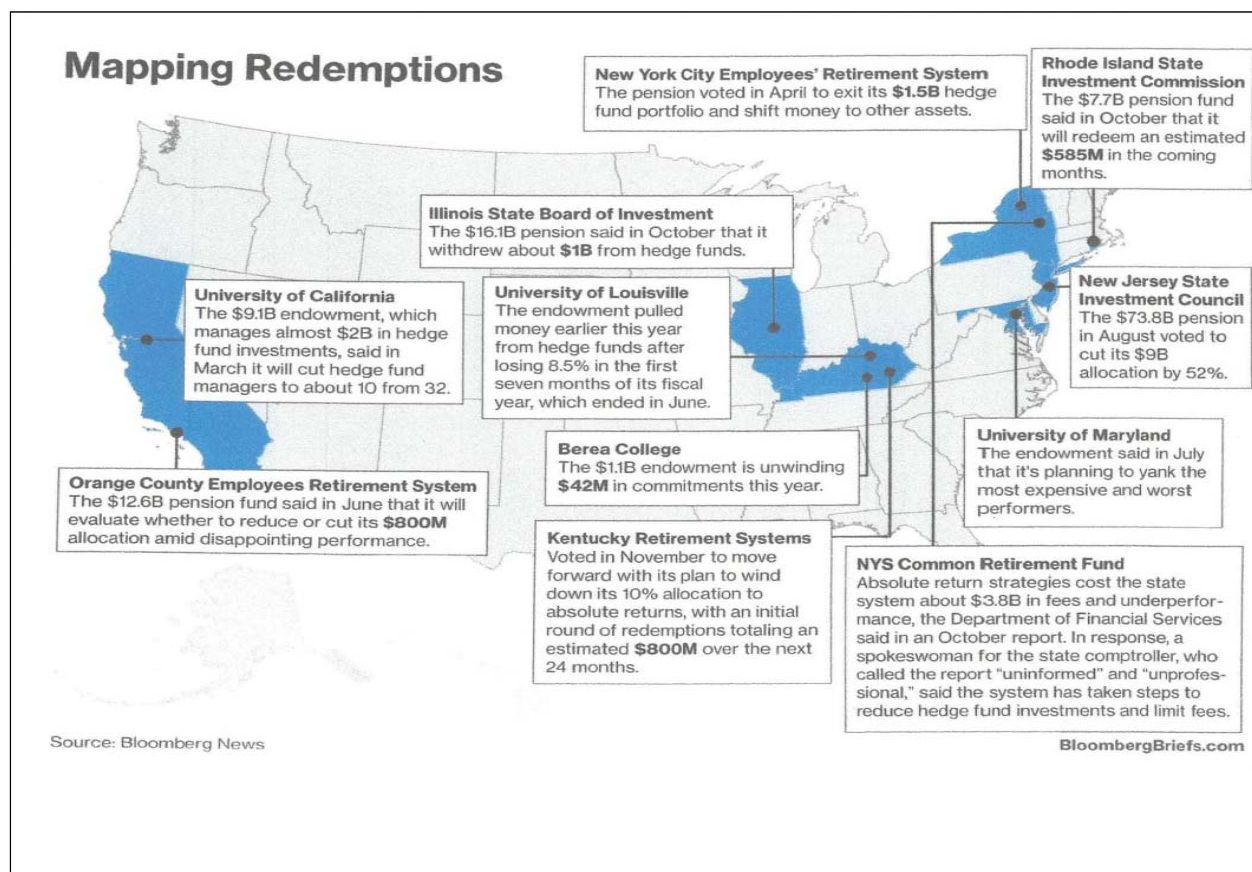
\* \* \*

Peden who worked at Prisma a decade ago and before it was taken over said the relationship ... “made it ... unnecessary to do a competitive process” ... Girish Reddy, co-founder of KKR Prisma, described the deal as a strategic partnership ...

168. Peden has admitted that KRS has had consistent difficulty in hiring experienced and qualified staff and that because KRS was “not fully staffed” he allowed Prisma employees to act as KRS staff *i.e.*, “essentially we use them as an extension of our staff”, while they were still paid by Prisma in what a KKR executive described as a “partnership”. He and Cook thus permitted an executive of KKR/Prisma with adverse legal interests to KRS and against whom KRS has valid and valuable legal claims to have access to its internal operations, data, information, strategies and discussions while causing KRS to agree to put \$300 million more into KKR/Prisma’s Daniel Boone Fund.

169. In 2016, while the current trustees were selling off \$800 million in high-fee, poorly performing hedge funds, with Cook as the Chair of the Investment Committee, his former employee Peden as the CIO and a KKR/Prisma executive working at their side inside KRS, Trustees put \$300 million more of KRS trust funds in the KKR/Prisma Black Box *i.e.*, the Daniel Boone Fund, on which the KRS Funds had recently suffered big losses. In fact, this Black Box was the worst performing of the Black Boxes. This “investment” was not done “solely” in the interest of the members and the beneficiaries but to help KRS but to help

KKR/Prisma and PAAMCO. During 2016, Hedge Fund sellers like KKR/Prisma suffered over \$100 Billion in outflows/ redemptions because of bad returns and expensive fees. The hedge fund industry was described as “an industry in crisis” at the time Cook, Peden and the trustees made this \$300 million addition to the Daniel Boone Fund. One 2016 headline makes the point: “**Hedge Funds Suffer Worst Outflows Since Financial Crisis Era,” Bloomberg, April 20, 2016.** The image below shows some the redemptions sweeping the hedge fund industry in 2016:



At this time, because of the contracting of the Hedge Fund industry, Kravis, Roberts, Reddy, and Buchan had begun to explore a combination of KKR/Prisma

and PAAMCO and to have \$300 million more assets under management benefited all of them, at the expense of KRS. This was self-dealing in the extreme.

170. This so-called “partnership” with a KKR/Prisma insider executive KRS acting as an “employee” of KRS while still being paid by KKR/Prisma, while advising KRS what to do with its Black Box fund of hedge fund vehicles, and then directing hundreds of millions of KRS dollars to KKR/Prisma while KKR/Prisma’s hedge business was facing redemptions and increasing outflows and loss of customers, violates the Kentucky Pension Laws conflict of interest prohibitions.

171. Because they are trustees and because they watch over the life savings (Trust Funds) of members and over taxpayer contributions to the Pension / Trust Funds in a non-profit enterprise, where the trust beneficiaries and taxpayers are involuntary participants, Trustees are not entitled to shield their actions and/or misconduct by the so-called “Business Judgment Rule” defense applicable to for-profit public corporations where shareholders can sell their shares and walk away if they are dissatisfied with the stewardship.

## **VI. HISTORY OF AMERICA’S PUBLIC PENSION PLANS**

172. Public pension funds proliferated and expanded after America’s WWII victory, amid the large and long post-war boom. Because wages had been controlled during World War II and labor shortages developed during the post-war period, employers in the public sectors began to offer pension benefits to attract and retain workers. Many public employees like policeman, fireman, and first responders, took dangerous jobs – which increased the risk of disability or early retirement. Because

secure pension and health benefits were promised by creating these pension benefits, government units helped to convince workers to accept dangerous job and other public employees to accept lower wages and/or wage increases because they could be certain they would receive a pension when they retired, after a lifetime of labor. As part of this trend, in 1956 the Commonwealth of Kentucky established the KRS.

173. In the 1950's, the idea of pension benefits as compensation as opposed to current pay, was new and untested – no one had retired. Shortly after World War II, Ford Motor Company workers rejected an offered pension benefit. Walter Reuther, a leading labor leader was critical of the very concept of pensions, fearing that the promises of pension, to be paid far in the future, would turn out to be an illusion. Some financial writers questioned the viability of the concept as well.

174. But resistance to the promises of a lifetime pension after many years of dangerous work by police and firemen and selfless service by social workers, public health workers, janitors and the like, was overcome. Workers in these new public pension plans were promised a fixed pension benefit based on years of service and salary levels, *i.e.*, a “defined benefit.” Government workers were promised that the pension funds established for their benefit would accumulate contributions from the employee and the government employer, albeit far less on a current basis than what would be necessary to pay the promised pension benefits many years later. Those contributions would be placed in trust, to be overseen, safeguarded and invested in a growing American (and world) economy by trustees. As markets increased over

time, with prudent investment of the trust funds assets and proper oversight and management of the funds, those investments returns would be sufficient so that when the time came for the fund to pay the promised benefits many years later, the money would be there.

175. Essential to the safety and success of any defined benefit pension plan was that plan assets – the contributions by the government employer and the employees’ wages – be placed in a trust to be overseen and invested by trustees who would be held to the highest standards of conduct – those required of a trustee who was holding, overseeing, safeguarding and investing monies belonging to other people, *i.e.*, public employees who were involuntary, passive beneficiaries in the pension funds and taxpayers who were legally obligated to pay for any funding shortfalls.

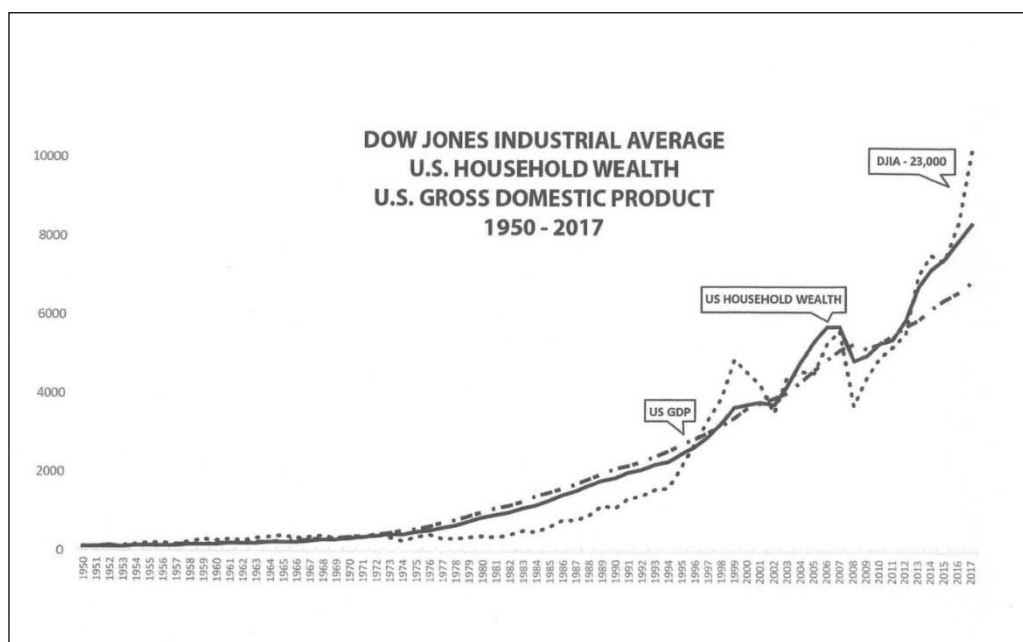
176. Workers were assured that having the pension fund assets overseen and cared for by trustees would be safer if people better trained than the workers themselves attempted to invest the money on their own, given their relative lack of sophistication and the danger that they would be taken advantage of by brokers, pitchmen and fast-buck artists. These trustees who were to oversee public pension plans were to assure that those pension plans would be the answer to the retirement dreams of millions of American public employees.

177. The idea behind these emerging public pension plans was straightforward. The American economy was expanding strongly in the afterglow of our victory in World War II. If those workers’ savings (and the tax dollars coming

from the government sponsor) were invested in that growing economy, over time the growth and success of the American economy would provide the investment returns which would provide the bulk of the funding of the promised pensions.

178. In 1956, in order to protect both the employees of Kentucky governmental units who would be covered by newly contemplated pension trusts, workers who would be required to be enrolled in and contribute to those plans, and also to protect the taxpayers of Kentucky who would be required to help fund those plans on an ongoing basis, the Kentucky Legislature enacted a law creating the KRS.

179. In fact, over the next 60 - 70 years the U.S. and world (economies markets) have done their part, as the graph below shows:



180. For the public employee pension funds all over our nation that have had the benefit of proper fiduciary stewardship, where the trustees have avoided reckless, imprudent or over-concentrated investments, such as secretive, opaque,

fund of hedge funds Black Boxes and their excessive fees, while using realistic assumptions about future investment returns, plan participant growth, retirement rates and longevity, and did not allow improper outside influences on fund investment decisions, the promises of pensions have been fulfilled. These funds are solvent, cash-flow positive and secure.

181. There are hundreds of public pension funds that are over 85-90% funded today. Over the past decades, through economic good times and bad, bull and bear markets, terrorists attacks, the savings & loan debacle, the dot.com/IPO and telecommunications debacles and even the 2007-2009 financial crisis – despite people living longer, retiring earlier and the slowing in public employee hiring – through one political crisis after another – despite all the vagaries of the past decades – because the trustees, investment advisors, actuaries, fiduciary counsel of these funds did their jobs and performed their statutory duties – they are well funded today. The retirement savings of their beneficiaries are safe. The treasuries of their states are not threatened. Examples of these well-funded plans are:

<b>Pension Fund</b>	<b>% Funded</b>	<b>Pension Fund</b>	<b>% Funded</b>
Connecticut Municipal Employees	86%	New York State Teachers	87%
Delaware State Employee	89%	North Carolina Local Govt.	95%
Employees Teachers State EES Tennessee State and Teachers	93%	North Carolina Local Govt. EES	91%
Florida Retirement System	85%	Oklahoma PERS	93%
Houston Fire Fighters	86%	Oklahoma Police Retirements System	99%
Iowa PERS	84%	Pennsylvania Municipal Employee Retirement System	100%

Los Angeles Fire and Police	94%	Sacramento County ERS	87%
Louisiana State Parochial Employees	99%	South Dakota Retirement System	100%
Main Local Govt. Employees	86%	South Dakota Retirement System	100%
Milwaukee City ERS	95%	Texas County and District	88%
Minnesota Police and Fire	88%	Texas Court and District Employees	88%
Missouri Local Employee	95%	Texas Teachers Retirement System	86%
Missouri PEERS	86%	Washington EES & School Employees and Teachers 2/3	88-92%
Missouri Teachers	86%	Washington, DC Police and Fire	110%
Montana County Employee	92%	Washington, DC Teachers	91%
Nebraska School Employees	90%	Wisconsin Retirement System	100%

182. There is no doubt that with proper, good faith trusteeship and pension fund management assisted by competent and experienced staff and honest independent outside advisors the public pension fund concept can work and does work. Look no further than Tennessee, right next door, where the two large public pension plans are 95% funded today. Those funds had competent trustees who obeyed the law and told the truth; and who had honest, competent and non-self-interested advisors; and who turned away sellers of speculative and unsuitable investments.

**VII. DEFENDANTS' SCHEME, CONSPIRACY AND  
CONCERTED COMMON COURSE OF CONDUCT  
THAT DAMAGED KRS, ITS FUNDS AND THE  
COMMONWEALTH**



**A. HUGE INVESTMENT LOSSES, SUSPICIOUS PAYMENTS  
SCANDAL AND THE USE OF OUTMODED, UNREALISTIC  
AND FALSE ACTUARIAL ASSUMPTIONS PLUNGE KRS INTO  
AN INTERNAL CRISIS IN 2009-2010**

183. Between 2002-2010, the funded status of the KRS Funds declined due to over \$6.6 billion in investment losses in 2000-2009. These losses gutted KRS' investment portfolio and demonstrated that the 7.75% AARIR Trustees had been using for years was unrealistic and would never be achieved on an ongoing basis. At the same time as billions of trust funds had been lost, the trustees were facing an accelerating increase in retirements. This required the Plans to pay out increasing amounts of benefits to more retirees, who were living longer. Slowing growth in government hiring/salary increases meant less new money coming into the Plans, with fewer new members and lower pay increases. Also, interest rates and inflation both plunged – and stayed low – as a result of the 2008-2009 market decline and economic downturn.

184. These problems were rooted in simple math. The 2009-2010 internal asset/liability study demonstrated there was no prudent investment strategy that would allow KRS to invest its way to significantly improved funded status. The trustees were trapped in a demographic/financial vise. The \$6 billion in 2001-2009 investment losses badly crippled future investment returns for years.

185. By 2009, KRS Funds had achieved an average annual rate of investment return of **negative -1.04%** (excluding dividends/interest) and only positive +1.91% (including dividends and interest) since 2000 – a ten-year period. Averaging these two actual return records yields an average rate of return from

2000 to 2009 of only +.44% – meaning that over the past 10 years, KRS had fallen billions and billions of dollars further behind. This was a gargantuan gap Trustees could never make up, yet Trustees and other Defendants continued to forecast a 7.75% AARIR for future years.

186. Not only was KRS not earning anywhere near 7.75% on an ongoing basis, it actually lost money on investments in four of nine years between 2001 and 2009, in five of twelve years between 2001 and 2012, and in seven of sixteen years between 2001 and 2016. The tables below show this<sup>14</sup>:

KENTUCKY RETIREMENT SYSTEMS					
NET APPRECIATION/DEPRECIATION IN FAIR VALUE OF INVESTMENTS					
(excludes dividends and interest)					
	NET APPRECIATION IN FAIR VALUE OF INVESTMENTS			ACTUAL RATE OF RETURN	PERIOD 2000 TO DATE
	Pension Funds	Insurance Funds	Total	(Note 1)	AVERAGE RETURN
6/30/2000	\$210,243,000	\$31,230,000	\$241,473,000	1.82%	1.82%
6/30/2001	(\$1,107,218,000)	(\$71,873,000)	(\$1,179,091,000)	(8.99%)	(3.58%)
6/30/2002	(\$872,569,000)	(\$134,227,000)	(\$1,006,796,000)	(8.20%)	(5.12%)
6/30/2003	\$109,972,000	\$6,272,000	\$116,244,000	0.97%	(3.60%)
6/30/2004	\$1,144,662,000	\$228,584,000	\$1,373,246,000	10.75%	(0.73%)
6/30/2005	\$723,831,000	\$122,127,000	\$845,958,000	6.12%	0.41%
6/30/2006	\$802,596,000	\$188,231,000	\$990,827,000	6.78%	1.32%
6/30/2007	\$1,507,855,000	\$366,809,000	\$1,874,664,000	11.78%	2.63%
6/30/2008	(\$997,369,000)	(\$282,385,000)	(\$1,279,754,000)	(7.94%)	1.45%
6/30/2009	(\$2,538,597,000)	(\$656,699,000)	(\$3,195,296,000)	(23.47%)	(1.04%)
6/30/2010	\$1,283,982,000	\$274,316,000	\$1,558,298,000	12.66%	0.21%
6/30/2011	\$1,658,548,000	\$517,042,000	\$2,175,590,000	15.92%	1.52%
6/30/2012	(\$261,180,000)	(\$118,700,000)	(\$379,880,000)	(2.70%)	1.19%
6/30/2013	\$890,282,000	\$232,863,000	\$1,123,145,000	7.98%	1.68%
6/30/2014	\$1,361,940,000	\$445,660,000	\$1,807,600,000	11.87%	2.36%
6/30/2015	(\$14,831,000)	\$3,890,000	(\$10,941,000)	(0.07%)	2.21%
6/30/2016	(\$201,845,000)	(\$51,543,000)	(\$253,388,000)	(1.65%)	1.98%

**Note 1:** The rate of return is calculated based on the average of the beginning of the year and end of the year investment portfolio as reported in the KRS audited financial statements for each respective year.

<sup>14</sup> The data presented in the column “Period 2000 to Date Average Return” is the cumulative moving average of the actual returns from the year 2000 forward to each respective year end.

KENTUCKY RETIREMENT SYSTEMS					
NET INVESTMENT INCOME(LOSS)					
(includes dividends and interest)					
	NET INVESTMENT INCOME(LOSS)			ACTUAL RATE OF RETURN (Note 1)	PERIOD 2000 TO DATE AVERAGE RETURN
	Pension Funds	Insurance Funds	Total		
6/30/2000	\$593,417,000	\$57,770,000	\$651,187,000	4.91%	4.91%
6/30/2001	(\$698,557,000)	(\$40,757,000)	(\$739,314,000)	-5.64%	(0.36%)
6/30/2002	(\$498,011,000)	(\$52,478,000)	(\$550,489,000)	-4.48%	(1.74%)
6/30/2003	\$430,925,000	\$28,231,000	\$459,156,000	3.82%	(0.35%)
6/30/2004	\$1,442,874,000	\$253,136,000	\$1,696,010,000	13.27%	2.38%
6/30/2005	\$1,059,095,000	\$157,643,000	\$1,216,738,000	8.80%	3.45%
6/30/2006	\$1,162,395,000	\$230,792,000	\$1,393,187,000	9.53%	4.32%
6/30/2007	\$1,915,774,000	\$423,390,000	\$2,339,164,000	14.70%	5.61%
6/30/2008	(\$579,947,000)	(\$220,598,000)	(\$800,545,000)	-4.97%	4.44%
6/30/2009	(\$2,232,950,000)	(\$611,310,000)	(\$2,844,260,000)	-20.89%	1.91%
6/30/2010	\$1,507,544,000	\$310,072,000	\$1,817,616,000	14.77%	3.08%
6/30/2011	\$1,902,223,000	\$561,188,000	\$2,463,411,000	18.02%	4.32%
6/30/2012	(\$28,527,000)	(\$55,320,000)	(\$83,847,000)	-0.59%	3.94%
6/30/2013	\$1,140,794,000	\$313,620,000	\$1,454,414,000	10.33%	4.40%
6/30/2014	\$1,643,041,000	\$527,067,000	\$2,170,108,000	14.25%	5.06%
6/30/2015	\$204,370,000	\$76,418,000	\$280,788,000	1.77%	4.85%
6/30/2016	(\$75,975,000)	(\$5,154,000)	(\$81,129,000)	-0.53%	4.53%

**Note 1:** The rate of return is calculated based on the average of the beginning of the year and end of the year investment portfolio as reported in the KRS audited financial statements for each respective year.

187. In 2010-2011, Trustees dramatically changed KRS' investment allocation by selling over \$1 billion of dividend-paying and interest-paying investments and placing those proceeds (and more) into Hedge Fund Sellers Black Boxes and other low/no dividend /interest paying investments *i.e.*, investments categorized as "absolute return assets," "limited partnerships," "private equity," and "real estate," sold to KRS by both Hedge Fund Sellers and other investment sellers. This eliminated millions of dollars of investment income from the KRS portfolio, and going forward the portfolio suffered very poor returns.

188. Having suffered the equivalent of two one-thousand-year floods, *i.e.* the 2001-2002 and 2008-2009, \$6.6 billion in losses in six years, and having

restructured the KRS investment portfolio by selling off over \$1 billion in dividend/interest bearing investments for low/no yield Black Box hedge funds and other non-income-producing investments, it was willfully reckless of Trustees to continue to use KRS' historical rates of return from an investment portfolio filled with dividend and interest paying investments to forecast an AARIR going forward for an investment portfolio filled with low/no dividend/interest paying investments, and billions of dollars of new "investments" that had no prior record of investment performance to rely upon.

189. In light of this actual record of performance, coupled with the increased allocation of investment assets to low/no dividend /interest paying investments, it was willfully reckless to assume that the KRS Funds were going to earn 7.75% every year forever going forward, but they did so to cover up their own failed stewardship. The graphs on page 98-99 show this, since they show that the average ongoing actual investment rate of return for this seventeen years was between 1.98% excluding interest and dividends, and 4.53% including interest and dividends, far short of the 7.75% represented and shown.

190. By 2010, KRS' Trustees and Officers and their investment, actuarial and fiduciary advisors realized that the Plans would not have the money to pay the promised pension distributions for which they were legally obligated, even assuming they earned their long-represented AARIR of 7.75% per year, every year, forever going forward, a rate of return they hadn't averaged, since it was set in 2006, and which they knew they couldn't ever reach on an ongoing basis. But they

also realized that if they honestly and in good faith factored in these realistic assumptions and known demographics trends, the published underfunded status of the Funds would skyrocket by billions of dollars, their stewardship would be vigorously criticized and investigated, resulting in them being ousted or even sued, a situation they wanted to avoid.

191. Trustees did not want to face these consequences, so rather than report the truth to KRS beneficiaries or the taxpayers in language that was “easily understood” by members and taxpayers, Trustees pursued a concerted common course of conduct with the other Defendants to disguise and mask the true condition of the Funds. They did so by manipulating and falsifying the key actuarial assumptions and estimates to cover up their own prior trusteeship/fiduciary failures, while making false statements and reassurances as to their prudence, care, diversification, avoidance of risk and undue concentration in investments. They looked for a way – somehow – to make up for the prior losses and miscalculations and estimates – to find higher investment returns – and to do so quickly.

192. As Trustees confronted the internal financial/actuarial crisis in 2009-2010, KRS was also being racked by internal Board turmoil and staff turnover, following revelations of \$12-15 million in “suspicious payments” to mysterious “placement agents,” which were disguised as “fees” until discovered by a special audit. As a result, the KRS CIO and ED were both fired. The Board Chair – a retired highway patrolman – was removed as Chair, but permitted to remain on the Investment Committee. This left Trustees with an interim ED who had no

investment experience or expertise, a new Board Chair, a new CIO and a Director of Alternative Investments, none of whom had experience with or expertise in “absolute return” fund of hedge fund vehicles.

193. During 2010-2011, as Trustees were being sold \$1.2-1.5 billion of Black Box funds of hedge funds, they were supported by insufficiently trained and inexperienced personnel while assessing whether to make this huge first-time, high-risk investment. These facts made it reckless for Trustees to rely on advice or reports from KRS staff as to the fund of hedge fund “investments” and Trustees were not acting in good faith if they did so.

194. In 2010-2011, RVK was a new investment advisor to Trustees, having been hired after the prior advisor had been discharged after the 2008-2009 losses, suspicious payment scandal and Arrowhead/Camelot exotic investing losses. RVK had no past record of performance with KRS for Trustees to rely upon and no significant experience in fund of hedge funds vehicles, so it would be reckless and not in good faith for Trustees to place reliance on this new investment advisor in betting 10% of the fund’s assets on funds of hedge funds.

195. During 2002-2010, KRS’ actuarial consultant, Cavanaugh Macdonald and fiduciary advisor, Ice Miller, had been consistently wrong and unduly compliant in the prior advice and guidance given Trustees for years – advice that had allowed Trustees to use outmoded, unrealistic and false/actuarial assumptions and AARIR, - the very errors and mistakes that had gotten them in the financial and actuarial

wise – such that continued reliance on the advice and recommendations of these Defendants by Trustees was reckless, not justified nor in good faith.

**B. THE BLACK BOX FUND OF HEDGE FUNDS DEBACLE, THE  
HIDDEN/ EXCESSIVE FEES AND THE TRUE RISKS AND NATURE  
OF THE BLACK BOXES**

**1. The KRS Trustees Are Sold the Black Box Fund of Hedge  
Funds**

196. The deteriorating status of the KRS Plans caught the attention of the Hedge Fund Sellers. Because they targeted pension plans, they had sophisticated knowledge of pension plan finances and because of internal information they obtained about KRS they knew the KRS Trustees and Officers were dealing with a much more serious situation than was known by the public. These Hedge Fund Sellers targeted KRS to sell it custom-designed “Black Box” funds of hedge funds that they portrayed as capable of producing the high investment returns with safe diversification while providing down-side protection – just what the desperate KRS Trustees were searching for. In fact, the Black Box vehicles were secretive, opaque, illiquid, impossible to properly monitor or accurately value, high-fee, high-risk gambles with no historical record of performance, where KRS was “locked in” for years and Hedge Fund Sellers had complete discretion to pick the investments and then to value them. They were completely unsuitable investments for the KRS Funds given the KRS Plans’ particular financial/actuarial situation.

197. Recent events should have alerted Trustees to the great danger of being sold “high yield/high return” exotic “investment” vehicles by Hedge Fund Sellers with “checkered pasts.” In 2009, the KRS trustees put trust monies into its first hedge fund type investments. Connecticut based Arrowhawk Capital Partners

was a hedge fund seller – a startup with no investment record. The trustees entrusted it with \$100 million. Arrowhawk was a flop. Under a cloud of controversy over its fees and lack of experience, it quickly folded. In 2009, the trustees made a multi-million dollar “investment” in The Camelot Group. Its owner was indicted for siphoning \$9.3 million to pay for personal extravagances. That fund also collapsed. Other contemporaneous events were front page news that should have been red flags to Defendants (the infamous Madoff scandal involving another New York-based investment manager who lost billions of investors’ money in “secret” Black Box investment strategies. The fund of hedge funds that Hedge Fund Sellers were creating and selling themselves had a “checkered past” of questionable legitimacy as investments whose existence arose from the infamous “Fund of Funds” scandals involving Bernie Cornfeld and Robert Vesco, where investors lost billions. Notorious hedge fund blowups included Long Term Capital, Galleon and others.

198. In an echo of the earlier Arrowhead and Camelot disasters, shortly after Trustees had been persuaded to hand over a \$1.2 billion three of the Hedge Fund Seller Defendants (KKR/Prisma, Blackstone and PAAMCO) to put into Black Boxes, one of the top personnel of one Black Box was implicated in criminal conduct. Hedge Fund Seller Blackstone had placed KRS trust monies (Henry Clay Fund) in a hedge fund run by SAC Capital, a business controlled by Steve Cohen, a Wall Street colleague well known to the Schwarzman and Toll, even though Cohen and SAC Capital were being investigated for financial misconduct at the time Blackstone gave some of its share of the KRS Trust Funds to Cohen. Top SAC Capital traders



were later criminally convicted and Cohen and SAC Capital were severely punished. Having again recklessly put KRS Trust monies in exotic vehicles sold to them by sophisticated Hedge Fund Sellers and again been burned, Trustees did not – as they should have – entirely remove their investments in the Black Boxes and put this money in safer, lower cost, more prudent investments handled by more reputable dealers. Nor did any of Defendants insist that they to do that.

199. KKR/Prisma, and its owner, KKR, along with Kravis and Roberts are regularly involved in complex financial transactions involving entities and/or individuals who owe fiduciary duties to others. The same is true of Blackstone and Schwarzman. Blackstone and KKR/Prisma have stated in government filings that because of the way they conduct their business activities, they face “substantial litigation risk.” Blackstone stated that the volume of such litigation has “been increasing.” Because of the aggressive tactics they use in financial transactions to gain unfair advantage for themselves, they or entities they control or operate have been sued on multiple occasions for misconduct in transactions involving fiduciaries. Schwarzman and Toll were also both top executives at Lehman Brothers, implicated as having a significant role in one of the largest Wall Street frauds of all time, and directly causing the 2008-2009 financial meltdown with consequent loss of billions in individual and institutional equity and a torrent of litigation alleging fraud. Both KKR and Blackstone have been fined by a government regulator for dishonesty and misconduct in their fiduciary capacity in connection with their fees charged to buyers of alternative investments like hedge

funds. Buchan and the other founders of PAAMCO had been sued for financial deception and dishonesty and found liable upon summary judgment as detailed earlier – acts of deception and dishonesty that when exposed got PAAMCO fired by other public pension funds due to the risk of continuing to do business with them. These individuals and the exotic and secretive vehicles they were selling had “checkered pasts” that should have been red flags to Trustees, and should have resulted in investigation with no investment, rather than investment without investigation.

200. Had Trustees been properly trained and educated and had they been skeptical and careful and properly counseled by their advisors and staff, the consideration of making an extraordinarily huge onetime, first of its kind, Black Box blind bet on what these Hedge Fund Sellers were trying to sell them on, in light of these facts, should have caused Trustees not to deal with Hedge Fund Sellers and not to buy what the Hedge Fund Sellers were selling, and to instead deal with other more reputable entities , offering more conventional, less high-risk, less high-fee, more transparent investments with a track record of performance. If the \$1.5 billion had been placed in a no/low-fee stock index fund like the S&P or DJIA, the \$1.5 billion would have turned into at least \$3 billion over the next seven years. If Trustees had simply stayed with the existing 2009 asset allocations, the Funds would have enjoyed investment results that would have left it far better funded than they are now, an opportunity for gains and income that is now lost due to imprudent investments.

201. Dealing with (i) Hedge Fund Sellers, with “checkered pasts” of their own or of the entities through which they operated, and who had been sued for breaches of duty and fraud in other complex financial and investment transactions and who even had to warn investors in other government filings of the “substantial litigation risk” their way of doing business exposed them to, and (ii) relying on the, and advisors who led Trustees to believe that these “Black Boxes” could make up for past investment losses and help overcome the underfunding of the KRS Pension Plans and help restore them to financial health – and with the approval of its Fiduciary Advisor and Investment Advisors, and also the approval of its Annual Report Certifier – Trustees recklessly gambled but it was KRS, its Plans and the Commonwealth who paid, and are paying, the cost.

202. The Black Boxes did not provide the investment returns Trustees needed for KRS to return to or exceed on the average its AARIR of 7.75%, did not provide safe diversification, provided very weak absolute and very bad relative investment returns and ultimately lost millions of dollars in 2015-2016—the very losses the “hedges” with their supposed “reduced volatility” and “safe diversification” would supposedly protect against. According to the investigative report issued by Consulting Group PFM (“PFM”) in 2017, “a roughly 10% allocation to hedge funds in the KRS Retirement System Plans had a negative impact on overall plan returns.” Further, the ongoing selloff of these hedge funds “is likely to result in improved performance and lower fees going forward.” PFM reported that “asset allocation,” including this 10% allocation to the “hedge funds” (and an 8-10%

allocation to Real Return assets) “has been the primary detractor of relative KRS performance.”

203. Kravis and Roberts, in addition to their own personal involvement in the KKR business, in law and in fact controlled all operations of KKR, KKR/Prisma (after its acquisition in 2012), and KKR/Prisma/PAAMCO at relevant times. As the responsible corporate officers, they had a duty to properly train all officers and employees who act as their agents and servants in the duties of good faith, care, loyalty, absence of self-dealing, compliance with applicable public pension laws and trust laws in states where they go to sell billions of dollars in hedge fund products, with external codes of conduct and care (such as the CFA) and internal codes of conduct and care, and with fiduciary duties owed by, respectively, KKR, KKR/Prisma and KKR/Prisma/PAAMCO officers, agents and employees, when selling or continuing to hold products and services. Further, Kravis and Roberts have a duty to supervise all officers, agents and employees and in the exercise of their fiduciary duties to KRS, and their duties of good faith, care, loyalty, code compliance, and the absence of self-dealing, a duty consistent and co-extensive with the *Caremark* corporate law duties to exercise appropriate attention and monitor subordinates’ behavior, “including the compliance with applicable statutes and regulations,” but here not limited or circumscribed by any business judgment rule defense. This they failed to do when dealing with KRS, to the damage of KRS and Kentucky taxpayers.

204. Schwarzman, in addition to his own personal involvement in the Blackstone business, in law and in fact controlled all operations of Blackstone at relevant times. As the responsible corporate officer, he has a duty to properly train all officers and employees who act as its agents and servants in the duties of good faith, care, loyalty, absence of self-dealing, compliance with applicable external codes of conduct and care (such as the CFA) and internal codes of conduct and care, and fiduciary duties owed by Blackstone officers, agents and employees, when selling or continuing to hold products and services. Further, Schwarzman has a duty to supervise all officers, agents and employees and in the exercise of their fiduciary duties to KRS, and their duties of good faith, care, loyalty, code compliance, and the absence of self-dealing, a duty consistent and co-extensive with the *Caremark* corporate law duties to exercise appropriate attention and monitor subordinates' behavior, "including the compliance with applicable statutes and regulations," but here not limited or circumscribed by any business judgment rule defense. This he failed to do when dealing with KRS, to the damage of KRS and Kentucky taxpayers.

205. Buchan, in addition to her own personal involvement in the PAAMCO business, in law and in fact controlled all operations of PAAMCO at relevant times. As the responsible corporate officer, she had a duty to properly train all officers and employees who acted as its agents and servants in the duties of good faith, care, loyalty, absence of self-dealing, compliance with applicable external codes of conduct and care (such as the CFA) and internal codes of conduct and care, and fiduciary

duties owed by PAAMCO officers, agents and employees, when selling or continuing to hold products and services. Further, Buchan had a duty to supervise all officers, agents and employees and in the exercise of their fiduciary duties to KRS, and their duties of good faith, care, loyalty, code compliance, and the absence of self-dealing. This she failed to do when dealing with KRS, to the damage of KRS and Kentucky taxpayers.

## **2. The Hidden/Excessive Fees**

206. In addition to being unsuitable investments, the purchase and holding of Black Box vehicles violated Trustees' duties to administer the Pension/Trust Funds in the retirement system in an "efficient and cost-effective manner for the taxpayers of the Commonwealth of Kentucky" and to operate KRS by incurring only "reasonable expenses." These speculative hedge fund vehicles contained double fees, many of which were hidden and impossible to measure accurately. The Hedge Fund Sellers were already charging very high and excessive fees to oversee and manage the funds of hedge funds they sold to KRS, on top of similarly high/excessive fees being charged by each of the hedge funds in which the Daniel Boone, Henry Clay and Colonels fund monies were placed.

207. Prisma, Blackstone, PAAMCO and later KKR/Prisma charged annual "management fees" of about 1% of the value of the Black Box funds they sold and then oversaw and managed, regardless of how the funds performed. They also took an "incentive fee" of 10-20% of any profits. There were larger hidden fees in the underlying Black Boxes. According to a source who has seen non-public KRS documents, the managers of its sub-funds charged 1.5-2.0% of assets under

management, regardless of performance plus 20% of all profits. A former KRS trustee who was on the Board during the relevant period calculated that in one two-year period, KRS paid Blackstone's sub-managers about \$40.5 million in fees; based on then similar fee structures, KKR/Prisma got about \$38.9 million in fees and PAAMCO received \$33 million in fees in just two years. KRS paid over \$150 million in fees in connection with the Henry Clay, Daniel Boone and Colonels funds during one 27-month span.

208. No one yet knows the true or total amount of these fees. According to the PFM report, the KRS internal records on fees paid to investment managers are contradictory and in disagreement, and the KRS records "do not include any performance based fees or other hidden costs." Thielen (KRS former ED) has admitted he did not know how much money was paid out in fees to the underlying funds. That information, he said was "proprietary" and even kept from him. In fact, and despite the Kentucky Pension Law's mandate to the contrary, Peden the-then CIO, said "the agency only cares about the net return on investment – after fees are subtracted" *i.e.*, they did not care about the costs and expenses of the \$1.2-1.5 billion plunge they took into Black Boxes. KRS and Kentucky's taxpayers have paid for Trustees' willful neglect of their clear duty to avoid unreasonable expenses and to manage the Funds in a cost-efficient manner.

209. As to these fees, a former KRS Trustee has stated: "These funds can't get them from anywhere besides public pension plans. Corporate plans are too

smart to pay these outrageous fees. The only stupid people are the taxpayers of Kentucky for letting these people get away with this.”

210. A report by CEM Benchmarking, Inc. (“CEM”) (a global benchmarking firm specializing in cost and performance of investment and administration) found the Kentucky Retirement Systems annual investment expenses in 2014 were actually more than 100 percent higher than what the system reported: \$126.6 million instead of the \$62.4 million Trustees reported. This number will be much higher when the true level of fees paid in connection with Black Box funds of hedge funds is known. According to a former KRS trustee:

KRS has squandered pension holders’ money by paying high fees for riskier investments with lower returns than unmanaged stock market index funds. He said his reading of the CEM report is that KRS’ investment underperformance of the last five years comes to about \$1.5 billion, a third of which stems from hidden fees.

### **3. The True Risks and Nature of the Black Boxes**

211. Although no such disclosures were ever made to KRS members/beneficiaries or Kentucky taxpayers, in different contexts and where they were legally required to tell the truth about the nature of the “fund of funds” hedge fund vehicles they sold and the true nature of the risks associated with them, the Hedge Fund Sellers laid it bare. The Hedge Fund Sellers are required to make filings with government agencies that disclose the true nature and risks of the products they sell. They are subject to civil, even criminal liability, if these filings are false or misleading.

212. The quotes below from KKR/Prisma are taken from filings signed by Kravis and Roberts. KKR/Prisma warned:



Hedge funds, including those in which our fund of funds are invested and the hedge funds we offer to fund investors may make investments or hold trading positions in markets that are volatile and which may become illiquid. Timely divestiture ... can be impaired by decreased trading volume, increased price volatility, concentrated trading positions, limitations on the ability to transfer positions in highly specialized or structured transactions to which they may be a party. It may be impossible or costly for hedge funds to liquidate positions rapidly ...

Moreover, these risks may be exacerbated for fund of funds such as those we manage.

\* \* \*

Investments by one or more hedge funds ... are subject to numerous additional risks including the following:

- ... there are few limitations on the execution of investment strategies of a hedge fund or fund of funds ...
- Hedge funds may engage in short selling, which is subject to theoretically unlimited loss ...
- We may enter into credit default swags (or CDS) as investments or hedges. CDS involve greater risks ...

\* \* \*

**Valuation methodologies for certain assets in our funds ... can be subjective and the fair value of assets established to such methodologies may never be realized, which could result in significant losses for our funds ...**

There are no readily ascertainable market prices for a substantial majority of illiquid investments for our investment vehicles ...

\* \* \*

**Risk of Loss.** Investing in securities involves risk of loss that investors in KKR Prisma Funds and Accounts should be prepared to bear. There can be assurance that the investment objectives of KKR Prisma Fund or Account, including risk monitoring and diversification goals, will be achieved, and results may vary substantially over time.

... Investments made by KKR Prisma Funds and Accounts may involve a high degree of business and financial risk that can result in substantial loss.

In all it took KKR/Prisma over 15 pages of single spaced typed to describe the true nature of, and risks associated with, its Black Box fund of fund vehicles.

213. The quotes below from Blackstone are taken from filings by Blackstone. Blackstone warned:

**Valuation methodologies for certain assets in our funds can be subject to significant subjectivity and the fair value of assets established ... which could result in significant losses for our funds.**

There are often no readily ascertainable market prices for illiquid investments ...

Because there is significant uncertainty in the valuation of, or in the stability of the value of illiquid investments, the fair values of such investments as reflected in an investment fund's net asset value do not necessarily reflect the prices that would actually be obtained by us on behalf of the investment fund when such investments are realized.

Many of the hedge funds in which our funds of hedge funds [invest] ... may choose to use leverage as part of their respective investment programs. The use of leverage poses a significant degree of risk and enhances the possibility of a significant loss in the value of the investment portfolio.

\* \* \*

Investments by our funds of hedge funds in other hedge funds, ... are subject to numerous additional risks, including the following:

- Certain of the funds are newly established funds without any operating history or are managed by management companies or general partners who may not have as significant track records as an independent manager.
- Hedge funds may engage in short selling, which is subject to the theoretically unlimited risk of loss ...
- Hedge fund investments are subject to risks relating to investments in commodities, futures, options and other derivatives, the prices of which are highly volatile and may be subject to theoretically unlimited risk of loss in certain circumstances ...
- Hedge funds are subject to risks due to potential illiquidity of assets.
- Moreover, these risks may be exacerbated for our funds of hedge funds.

In all it took Blackstone 15 pages of single spaced type to describe the true nature of, and risks associated with, its Black Box hedge fund vehicles.

214. In a government filing on Form ADV, PAAMCO made similar risk disclosures, requiring a total of 12 pages to set forth all the risks of its hedge funds products.

215. If the KRS trustees actually ever read or understood these risks, they were even more willfully reckless to commit \$1.2-1.5 billion, which was 10% of the Trust/Pension Funds, and all at one time on these fund of hedge funds. The Hedge Fund Sellers should never have sold these products, no matter what “warning” was buried in the paperwork, and the Investment Advisor and Fiduciary Advisor never should have permitted the sale of these products to KRS as they were absolutely unsuitable investments for a pension fund in the particular situation KRS was in, and violated the applicable laws, codes and standards. The true nature and extent of the risk of these so-called “investments” was never disclosed to the KRS members or beneficiaries, or Kentucky taxpayers in any, let alone “easily understood,” language, and this failure of disclosure to KRS members and beneficiaries and the Commonwealth, was known to the other Defendants because they received and reviewed KRS’ Annual Reports.

216. Even though they were under a duty to provide accurate, truthful information regarding the KRS Plans’ financial and actuarial condition in the Annual Reports in a manner that was “easily understood by the members, retired members and the public,” during the relevant time period the most ever disclosed by Trustees and/or Officers, the Investment, Actuarial and Fiduciary Advisors and the Hedge Fund Sellers was deep within the 180+ page long reports. That information

was that the “Absolute Return” “investments” had “excellent potential to generate income” and “may” have a “higher degree of risk.” “May” is not “do.” “May” is a statement of the obvious and a highly misleading one given the accompanying false assurances that these “investments” provided “safety and less volatility,” “increased diversification,” had “excellent potential for increased income,” and that they would “help get KRS to” or enable it “to exceed” its 7.75% AARIR – all part of Trustees’ continued “adherence to high standards.” In truth, these Black Boxes were secretive, opaque, illiquid vehicles, toxic “investments” that carried excessive and hidden fees, were impossible to accurately monitor or value, had no prior track record of performance and carried a very high and unacceptably large risk of losses.

**C. DEFENDANTS’ FALSE AND MISLEADING STATEMENTS AND REASSURANCES – AND OBFUSCATIONS – TO KRS MEMBERS AND KENTUCKY TAXPAYERS**

217. As required by the Kentucky Pension Law, every year the trustees published a Comprehensive Annual Report for KRS members, government officials and taxpayers. It is the primary means of communication by the trustees to KRS members and Kentucky taxpayers. It was required to be in “easily understood language” to allow KRS members and beneficiaries, government officials and taxpayers to be informed as to the true financial and actuarial condition of the KRS Funds and the stewardship of the trustees.

218. The police, clerks and social workers, the firefighters, sheriffs and the like, who are members of the KRS Plans are not required to be forensic accountants or actuaries or lawyers with fiduciary and trust expertise. They are not required to be private eyes, searching through 180-page-long, two-pound Annual Reports to

ferret out if Trustees, who are supposed to be looking after them, are telling them the truth as the Kentucky Pension Law requires them to do. The Annual Reports published by the trustees during the relevant time period did not give a true, accurate or “fair presentation” of the actual financial and actuarial condition of the KRS Plans in “easily understandable” language. Instead, over the past several years the Defendants have worked together as part of their concerted common course of conduct and enterprise to make or permit to be made, false statements, reassurances and obfuscations to KRS members and beneficiaries and Kentucky taxpayers.

219. Trustees promised that the KRS Annual Reports would:

Provide complete and reliable information ... as a means of determining compliance with statutory provisions, and as a means of determining responsible stewardship of KRS funds.

220. The KRS Website year after year represented:

The Board of Trustees is charged with the responsibility of investing the Systems assets ... the Board follows a policy of thoughtfully growing our asset base while protecting against undue risk and losses in any particular investment area. The Board recognizes its fiduciary duty not only to invest the funds in compliance with the Prudent Person Rule, but also to manage the funds in continued recognition of the basic long-term nature of the Systems. In carrying out their fiduciary duties the Trustees have set forth clearly defined investment policies, objectives and strategies for the pension and insurance portfolios.

221. The KRS Annual Reports constantly reassured KRS beneficiaries and Kentucky taxpayers how the trustees carefully safeguarded and invested the KRS assets:

The Board of Trustees of the Kentucky Retirement Systems has a statutory obligation to invest KRS’ funds in accordance with the “prudent person rule.” The prudent person rule states that fiduciaries shall discharge their

investment duties with the same degree of diligence, care and skill that a prudent person would ordinarily exercise under similar circumstances in a comparable position.

The Board has interpreted this to mean that the assets of the systems should be actively managed – that is, investment decisions regarding the particular securities to be purchased or sold shall be the result of the conscious exercise of discretion. The Board has further recognized that proper diversification of assets must be maintained. It is through these policies that KRS has been able to provide significant returns over the long-term while minimizing investment related expenses.

222. For seven straight years, from 2010 to 2016, in various and multiple communications to KRS members and Kentucky taxpayers, Trustees created a mosaic of false and misleading statements and reassurances that were intended to and did give a false sense of security as to the Funds and the quality of their stewardship. Trustees misrepresented that, in performing their fiduciary duties, the Board “follows a policy of preserving capital,” by “protecting against undue losses in any particular investment area” “by means of clearly defined investment policies.” Trustees consistently misrepresented their investment procedures and practices when they stated (i) “the Board follows a policy of thoughtfully growing our asset base while protecting against undue risk and losses in any particular investments”; (ii) the “portfolios are diversified on several levels ... through the use of multiple asset classes[that] represent an efficient allocation to achieve overall return and risk characteristics”; (iii) “portfolios within each of the asset classes are diversified through investment strategies”; and (iv) with “new allocations to the ... absolute return buckets – going forward the portfolio is more diversified than ever.”

223. Contrary to assurances that the “absolute return” assets and strategies would provide safe diversification and reduced risk and volatility, the funds of

hedge funds did not safely increase diversification but rather were a reckless blind bet. The three \$400-plus million plunges into the Black Box funds of hedge funds were the three largest single investments in the history of KRS. These were over-concentrated plunges into essentially identical vehicles with no track record and therefore no way to forecast reliably any future performance. For fiduciary investors to put \$400 million, let alone \$1.5 billion, all at one time into an unknown investment vehicle with no track record is extremely reckless. Fiduciary investors test out strategies—they do not plunge into the deep end with a blindfold on. In total, the \$1.2 billion plunge (later \$1.5 billion) was the largest one-time investment in a single asset class in the history of the KRS Funds. By comparison, KRS’ largest individual domestic equity investments were in the \$50-\$75 million range and in international equity the largest investment was in the \$24-\$35 million range. Even in the safe fixed-income area, the largest KRS investment was about \$175-\$225 million.

224. As Trustees were searching to find a way to quickly boost investment returns in 2009-2010, what was put in KRS Annual Report for 2010 about its internal “asset/liability” study was obfuscation at best, deliberate deception at worst.

Toward the end of the fiscal year, the Board made an important decision to commission RVK to conduct asset-liability studies for the KRS, CERS, and SPRS pension and insurance plans. The studies ... were done because the severe market downturn in 2008 into early 2009 significantly lowered the funded ratio across all investment plans it became evident to the Board that it was necessary to better align the asset allocation decisions of the plans with the future and growing corresponding liabilities.

\* \* \*

The studies revealed several plans, the KRS Non-Hazardous Pension Plan, face the possibility of converting to a pay-as-you-go model. Using “what if” scenarios, analysis shows that under very weak investment market conditions coupled with the consistent underfunding of the pension contributions over the next 10 years, the pension fund could deplete its assets in an attempt to meet escalating benefit payments. The asset-liability study assisted the Board with deciding on the most effective asset allocation strategies for each pension and insurance plan under its purview in order to lower risk, control the level of illiquidity in the portfolios, and generate a return expected to exceed the actuarially assumed rate of return of 7.75% ... As of 2010 - 2011 ... the Board has been transitioning to the new ... asset allocations – in a prudent manner.

\* \* \*

... We expect the Board’s continued high standard of care for these assets and commitment to diversification to allow the System to meet its long-term goals and objectives.

225. In August 2011, just after Trustees were persuaded to put the first \$1.2 billion in the Black Boxes, T.J. Carlson (the CIO of KRS) stated:

The new allocation is part of the system’s new absolute-return asset class ... “The main reason (for the new absolute-return strategy) is to reduce volatility in the portfolio overall ... [and] to get our expected rate of return of 7.75%. Absolute return helps us maintain our expectations but lowers our risks.”

226. RVK’s letter to KRS members and Kentucky taxpayers in the 2011 Annual Report again reassured:

The Systems investment policies as well as the performance of its assets are regularly monitored ... by RVK Kuhns & Associates, Inc. These evaluations include reviews of the investment management firms ...

\* \* \*

We expect the Board’s continued high standard of care for these assets and commitment to diversification to allow the Systems to meet its long-term goals and objectives.

227. After Trustees had put \$1.5 billion into the Black Box vehicles, in the KRS 2012 Annual Report, RVK stated in a letter signed by Gratsinger:

Questions surrounding how pension funds will meet their expected return targets and thus fund their liabilities are valid. Many funds are faced with the need to boost returns in this environment and have turned to alternative



investments ... absolute return strategies. ... KRS has also moved in this direction. New target asset allocations were approved ... in response to recently completed asset liability modeling studies. These new asset allocation guidelines ... call for ... new allocations to the ... absolute return buckets, so going forward the portfolio is more diversified than ever.

228. Each of RVK's reports in the 2012, 2013, 2014 and 2015 KRS Annual Reports to members and taxpayers, which were signed by Gratsinger, continued to falsely reassure KRS beneficiaries and taxpayers:

KRS portfolios are diversified on several levels. Portfolios are diversified through the use of multiple asset classes ... and represent an efficient allocation to achieve overall return and risk characteristics. The individual asset classes are diversified through the use of multiple portfolios ... Finally, portfolios within each of the asset classes are diversified through the selection of individual securities.

The System's investment policies are regularly monitored by KRS staff, the Board and R.V. Kuhns & Associates, Inc. These evaluations include reviews of investment management firms ...

We expect the Board's continued high standard of care for these assets and commitment to diversification to allow the Systems to meet its long-term goals and objectives.

229. Trustees caused key false reassurance by the investment advisor RVK to be blown up and featured in the Annual Reports with extra prominence:

*"An uncertain market environment demands careful attention and thoughtful treatment of the assets entrusted to the Board's care by the Systems' employee participants. We expect the Board's continued high standard of care for these assets and commitment to diversification to allow the Systems to meet its long-term goals and objectives."*

*Rebecca A. Gratsinger  
CEO, Principal  
R.V. Kuhns & Associates*

230. The KRS Annual Reports for the past several years contained a presentation of the actuarial position of the KRS Plans certified by Cavanaugh

Macdonald in a report/letter signed by Cavanaugh Macdonald. From 2011 to 2015, the Cavanaugh Macdonald actuarial reports each represented that these “reports describe the current actuarial condition of the Kentucky Retirement System”:

The Board of Trustees in consultation with the actuary sets the actuarial assumption and methods used in the valuations ... These assumptions have been adopted by the Board ... in accordance with the recommendations of the actuary.

\* \* \*

**Progress towards Realization of Funding Objectives.** The progress towards achieving the intended funding objectives, both relative to the pension and insurance funds, can be measured by the relationship of actuarial assets of each fund to the actuarial accrued liabilities. This relationship is known as the funding level and in the absence of benefit improvements, should increase over time until it reaches 100%.

\* \* \*

Based on the continuation of current funding policies by the Board, adequate provisions are being determined for the funding of the actuarial liabilities of the Kentucky Employee Retirement System, ... as required by the Kentucky Revised Statutes. The funding rates established by the Board are appropriate for this purpose.

231. From before 2000 onward, each KRS Annual Report represented that because of the trustees’ and officers’ “outstanding stewardship,” KRS had again received a prestigious award, a “Certificate of Achievement” from the “Government Finance Office Association of the United States” for “Excellence in Preparation of its financial reports” and for publishing an “easily readable and efficiently organized document” which satisfies “applicable legal requirements.”

232. This certificate and award was featured prominently in every Annual Report for years, often pictured on the same page as the pictures of the trustees. The GFOA Award and certificates were prominently featured – right beside the trustees. Not a word was changed from prior years in the GFOA certification and award to the trustees in the KRS 2016 Annual Report – published as of December 1,

2016. By that time, questions were being raised about the stewardship of the Funds, and an independent outside investigation had been commissioned in September, 2016 by the Executive Branch of Kentucky state government in order to “accurately identify our actual pension liabilities ... to shine the light of transparency on the country’s worst-funded pension system,” an investigation that was to be “the most exhaustive review ever conducted” and was to include “overall solvency and liquidity analysis” in order “to identify reasons for the current financial status of the plans.”

233. The actions of the GFOA in light of these circumstances constitute reckless conduct in willful disregard of its duties to KRS, its members and Kentucky taxpayers. GFOA has provided a “rubber-stamp” award for years, in dereliction of its duties.

#### **D. THE 2017 DISCLOSURES AND NEAR COLLAPSE OF THE KRS PLANS**

234. On February 16, 2017, The Lexington Herald Leader reported:

##### **TROUBLED KENTUCKY PENSION SYSTEM MIGHT NEED BILLIONS MORE THAN ASSUMED**

Kentucky Retirement Systems ... might be in far worse financial shape than previously thought.

\* \* \*

KRS made serious math errors in recent years by relying on overly optimistic assumptions about its investment returns, the growth of state and local government payrolls, and the inflation rates, KRS board chairman John Farris told his fellow trustees ...

For example, KRS assumed that it would earn an average of 6.75 percent to 7.5 percent on money it invested, but it earned an average of 4.75 percent, Farris said. KRS assumed that public payroll would grow by 4 percent a year through pay raises or more government hiring – a larger

payroll means larger pension contributions by employees – but public payroll has dropped overall because of repeated budget cuts, he said.

“It doesn’t make any sense,” said Farris ... “We wonder why the plans are underfunded. It’s not all the legislature’s fault. It’s the board’s responsibility to give the correct numbers.”

235. On May 18, 2017, the Lexington Herald Leader reported:

### **KENTUCKY’S PUBLIC PENSION DEBT JUST GOT BILLIONS BIGGER**

Kentucky’s public pension debt just got a few billion dollars bigger

Under the new numbers presented to the board, KRS’ official unfunded pension liability of \$18.1 billion will increase by somewhere between \$3.6 billion and \$4.5 billion ...

\* \* \*

Following Thursday’s board vote, the primary state pension fund operated by KRS – known as the Kentucky Employees Retirement System (Non-Hazardous) – has only 13.81 percent of the money it is expected to need in coming years ...

\* \* \*

“The most important function of our board is to give correct numbers to the legislature,” Farris said. “If we don’t do that, if we continue to rely on aggressively optimistic assumptions, then we will continue to fall behind.”

\* \* \*

KRS had assumed that it would earn from 6.75 percent to 7.5 percent on money it invested; it assumed that public payroll would grow by 4 percent a year; and it assumed an inflation rate of 3.25 percent. All of those numbers look unrealistic.

\* \* \*

“We (at KRS) have been “aggressive” in our assumptions for many years – aggressively wrong,” Farris said. “And we wonder why we’re underfunded.”

236. During 2016-2017, independent eyes got to look at what had gone on inside KRS for the past several years when the PFM investigation of KRS was commissioned by the Executive Branch. In 2017, PFM issued the “PFM Report,” which was described in media reports as follows:

### **KENTUCKY’S PENSIONS ARE WORST-FUNDED IN U.S., STUDY SHOWS**

A new study shows that Kentucky has the worst funded pension system in the nation

**... And from another media report:**

The PFM Group today presented an alarming report to the Public Pension Oversight Board detailing the factors that made Kentucky's pension systems the worst funded systems in the United States. The report revealed that the systems have had a combined \$6.9 billion negative cash flow since 2005 as benefits paid to retirees plus program expenses greatly exceeded appropriated funding. According to the report, if this negative cash flow is not corrected, the ability to make payments to current and future retirees is at risk ... "PFM's analysis is the most comprehensive and detailed look at the many factors that contributed to the massive unfunded pension liabilities crippling our state," stated John Chilton, Kentucky's State Budget Director.

\* \* \*

237. The Executive Branch of the Commonwealth has stated:

**The KRS and TRS plans have taken on significantly more investment risk over the last decade in order to chase unrealistically high investment returns.** (emphasis added).

When compared to other public plans, the KRS plans have had an allocation to riskier alternative investments that nearly double the peer average. Unfortunately, significant exposure to market risks still remains."

\* \* \*

Billions in pension debt are growing in perpetuity ... even if the plans earn their expected investment return ...

238. On August 24, 2017, the Lexington Herald Leader reported:

**FORMER HEAD OF KENTUCKY RETIREMENT SYSTEMS  
'SHOULD BE IN JAIL,' BEVIN SAYS**

Gov. Matt Bevin told a gathering of Kentucky's city and county leaders Thursday that the former executive director of the financially ailing Kentucky Retirement Systems deserves to be in jail.

\* \* \*

"Bill Thielen should be in jail and that's a fact. And I don't know who's here from the media but if this was a private company, if this was a private pension plan he would be."

"It has been negligent, it has been irresponsible and it is shameful".

“What has been done in our pension systems has been criminal,” Bevin said ... “if these were private companies they would have been taken over and frozen and disbanded and the payouts of benefits would have been stopped by law.”

#### **E. THE COMMONWEALTH HAS BEEN HARMED**

239. There have been wrongful acts on the part of the KRS Trustees and Officers to the detriment of KRS, a public body, which they controlled, damaging KRS and the Commonwealth of Kentucky and its taxpayers. Plaintiffs, as members of the Plans and as Kentucky taxpayers, have the right to pursue the taxpayer claims asserted herein independently.

240. The financial collapse of KRS has caused an increasingly large drain on the Kentucky treasury and taxpayers, contributing to significant curtailments of social and educational spending, hurting the pocketbooks and the quality of life for millions of Kentucky citizens. Because of the KRS Trust/ Pension Fund fiasco, Moody’s and Standard & Poors have slashed Kentucky’s credit rating, leaving Kentucky with the worst – or one of the worst – credit ratings of any state, facing more spending cuts to important programs and/or massive tax increases to make up for the funding deficits caused by the breaches of duty and misconduct of Defendants complained of herein. Kentucky has poured billions of tax dollars into KRS in recent years, and going forward will have to pour billions in tax dollars into KRS above and beyond the tax expenditure which would have been necessary had Defendants told the truth and complied with their legal obligations when they were required to do so.

241. Plaintiffs plead their taxpayer claims in their own right having independent standing to do so. Plaintiffs also demanded that the Attorney General pursue these claims on behalf of the Commonwealth. He has declined to do so as set forth herein. For the foregoing reasons, Plaintiffs proceed on the taxpayer claims in *parens patriae*.

242. KRS is funded by a combination of contributions by Kentucky public employees (members/beneficiaries) and public tax dollars. Any financial shortfall of the KRS funds is ultimately the responsibility of Kentucky taxpayers. The legal duties owed by Trustees and the other Defendants under Kentucky law are owed to KRS and its members and beneficiaries and to the Commonwealth and its taxpayers as well.

243. KRS is a component unit of the Commonwealth of Kentucky. The Kentucky Pension law was enacted for the broad public good of the Commonwealth. A strong, healthy, well-functioning public pension system not only protects the public employees who then have good, secure pensions and health benefits, it benefits the entire Commonwealth by attracting qualified people to work as clerks, police officers, firefighters and public servants. A well-managed public pension system creates collateral benefits for the entire Commonwealth; the public tax monies contributed to KRS as its trust funds were adequate to accomplish that had they been safely, prudently, and carefully invested, just as has been achieved in other states where public pension funds have been properly managed.

244. The KRS Trustees and Officers are responsible for billions of dollars of tax monies contributed in the past, embedded within the KRS Funds assets today, and those to be contributed in the future under Kentucky's ongoing legal obligation to back-stop the Funds. They have statutory duties pursuant to the Kentucky Pension Law and Trust Law to comply with those laws in their handling and oversight of those tax dollars. Defendants are responsible for the damage their individual and joint misconduct has caused KRS and the Commonwealth.

245. The safety and security of the KRS Pension Funds requires ongoing and ultimately unlimited funding by the Commonwealth. The 2016-2017 revelations of the true extent and nature of the KRS' Funds' financial losses, and the consequences of the use of misleading and false actuarial assumptions, now confront the Commonwealth with a financial crisis of many billions of dollars. If Trustees (and those working in concert with them) had told the truth in 2010 and thereafter as the law required them to do, had they then in good faith used realistic and truthful estimates and assumptions, as the law required them to do, then there would have been more time within which to address the underfunding, the deteriorating demographics, the anemic investment returns and the losses and funding deficits. The scope of the financial crisis would have been billions less than it is now, and it would have been manageable and solvable at a lower, more reasonable, cost. All Defendants should be held to account for the damage their individual and/or joint misconduct through their scheme, conspiracy and concerted



common course of conduct and enterprise, have caused KRS and the Commonwealth.

246. As further consequence of all Defendants' failure to tell the truth from 2009 on, a "false sense of security" resulted in lower-than-required annual contributions to the KRS Trust Funds from the governmental sponsors. At the same time, the breaches of duty described herein resulted in avoidable waste of those funds that were contributed. The \$3.6 billion in taxpayer funds put into KRS during 2009 – 2015 was in effect obtained under false pretenses, and then thrown down a hole by virtue of Defendants' imprudent investment practices. KRS is now dangerously underfunded and many extra billions of tax dollars will be needed to fix a problem that could and should have been fixed years earlier had those under a legal duty to tell the truth and act with care and prudence and solely in the best interest of the Funds done so. Instead they chose to cover up and speculate in hopes of catch up, which has cost KRS and the Commonwealth billions of dollars.

**CAUSES OF ACTION  
FOR KRS AND THE COMMONWEALTH AND ITS TAXPAYERS**

**COUNT I  
AGAINST THE KRS TRUSTEES FOR  
BREACH OF TRUST AND FIDUCIARY DUTIES**

247. Plaintiffs incorporate by reference the allegations set forth in the preceding paragraphs.

248. Trustees, by the actions and inactions alleged herein, acted in a willful or reckless manner and breached their statutory, trust, common law and fiduciary duties to KRS and Kentucky's taxpayers.

249. KRS, its Pension/Trust Funds and the Commonwealth have sustained and will continue to sustain significant damages.

250. Trustees willful and reckless actions and failures to act were a substantial factor in causing the damages alleged herein, both those that have occurred and will in the future occur.

251. As a result of the misconduct alleged herein, Trustees are liable to KRS and the Commonwealth for damages in an amount to be proven at trial.

252. The damages alleged herein are applicable to each of COUNTs I, II, III and IV, and consist of any and all provable damages to KRS and the Commonwealth, which include, at a minimum, the following: (i) damages for the losses incurred by KRS as a result of breaches of fiduciary and other duties, including unsuitable investments, the loss of trust assets, the loss of prudent investment opportunities and the loss of positive investment returns; (ii) disgorgement of fees from appropriate Defendants which each received from the sale of, the continued holding of, and the management of, unsuitable hedge fund products, and the providing of certification of fiduciary standards; and (iii) the increased costs to the Commonwealth of restoring KRS and its Pension/Trust Funds to properly funded status, after years of concealment of the true financial condition of KRS and the waste of its funds.

## **COUNT II**

**AGAINST THE KRS TRUSTEES AND OFFICERS, HEDGE  
FUND SELLERS, ACTUARIAL, FIDUCIARY AND INVESTMENT  
ADVISORS AND ANNUAL REPORT CERTIFIER FOR  
BREACHES OF STATUTORY, FIDUCIARY AND OTHER DUTIES TO KRS**

253. Plaintiffs incorporate by reference the allegations set forth in this Complaint.

254. Under the language of the Kentucky Pension Law, and also (i) because their roles gave them constant access to non-public information of KRS and its Pension Funds (ii) because they held themselves out to be very sophisticated, highly qualified experts with extensive experience and expertise in their respective fields (iii) because they knew the KRS Trustees were dealing with internal turmoil and staff turnover and new and inexperienced investment staff and investment advisors and would be unusually dependent upon their professed, superior experience, expertise, and sophistication in their respective areas of expertise and (iv) because in the case of the Hedge Fund Sellers and RVK, both were also acting as investment advisors and/ or investment managers for KRS – the Hedge Fund Sellers, and the Investment Actuarial and Fiduciary Advisors were all fiduciaries to KRS.

255. Each of the Defendants by their actions and inactions, as alleged herein, acted in a negligent manner and failed to exercise due care and failed to fulfill their statutory and other duties, including their fiduciary duties, to KRS and its Funds and to the taxpayers of Kentucky.

256. KRS, its Pension/Trust Funds and the Commonwealth have sustained and will continue to sustain significant damages, as alleged in COUNT I

257. Defendants' negligent actions and failures to act were a substantial factor in causing the damages alleged herein.

258. As a result of the misconduct alleged herein, all Defendants named in this Complaint are liable to KRS and the Commonwealth for damages in an amount to be proven at trial.

### **COUNT III**

#### **AGAINST ALL DEFENDANTS FOR PARTICIPATING IN A JOINT ENTERPRISE AND/OR A CIVIL CONSPIRACY, INCLUDING ONE OR MORE OF A SCHEME, COMMON COURSE OF CONDUCT, AND CONCERTED ACTIONS**

259. Plaintiffs incorporate by reference all the allegations set forth in the Complaint.

260. Each Defendant knowingly played an important and indispensable part in a scheme, civil conspiracy, concerted actions, common course of conduct, and joint enterprise for their own, and their joint, economic gain to the damage of KRS and the Commonwealth. Defendants worked together, knowing the roles of the others and each taking the specific overt acts alleged herein within their special areas of expertise and knowledge to further the civil conspiracy. Each Defendant profited from participation in the scheme. In order for the scheme to succeed as it did, it required the continuing, conscious mutually supportive and overt acts of each Defendant. Had any one of them complied with their duties to KRS or the Commonwealth, the damages could have been mitigated or avoided.

261. After the huge losses of 2001-2002 and 2008-2009, the internal asset/liability study revealed a dangerous mismatch and a looming liquidity threat. While concealing the true state of affairs, Trustees searched for some kind of high-yield “home run” investment to rescue themselves from and to cover up their own failed stewardship.

262. Rather than face the public outcry, uproar, political firestorm and inquiries that would have resulted had they told the truth in 2010-2011 as the law required them to do – rather than honestly disclosing the true facts and seriousness of KRS’ financial/actuarial situation, so that proper and prudent steps could be taken then to rescue the funds, secure increased state funding at that time and assure the KRS Pension funds were prudently invested going forward – Defendants obfuscated, misled and falsely reassured KRS’ Pension members and beneficiaries and Kentucky taxpayers and bet billions on speculative “absolute return” and “real return” “investment” strategies that failed.

263. The Hedge Fund Sellers sold the high-fee, high-profit Black Box vehicles to Trustees even though they and RVK knew the extremely high-risk, high-fee, speculative vehicles were unsuitable investments for KRS given its particular financial/actuarial situation. Then, even though the Kentucky Pension Law required Defendants to tell the truth – the complete unvarnished truth – in “easily understood” language to KRS retirees, beneficiaries and Kentucky taxpayers – the Defendants did not do so.

264. Each Defendant made or permitted to be made statements they knew were false and/or misleading assurances and obfuscations to KRS members and beneficiaries and Kentucky taxpayers through the KRS Annual Reports, which created a false sense of security, a false sense of good stewardship and a false sense of legal compliance. These statements include:

- Trustees were “performing their fiduciary duties.” “Investment decisions” were “the result of the conscious exercise of

discretion;” “proper diversification of assets must be maintained” and Trustees’ policies “provide significant returns over the long term while minimizing investment related expense.”

- Trustees “follow a policy of preserving capital” by protecting against ... undue losses in a particular investment area.”
- KRS portfolios “are diversified through the use of multiple asset classes” ... “which represent an effective allocation to achieve overall return and risk diversification.”
- “The Board decid[ed] on the most effective asset allocation strategies ... to lower risk, control the level of illiquidity in the portfolios, and generate a return expected to exceed the actuarially assumed rate of return of 7.75%.
- “The main reason (for the new absolute-return strategy) is to reduce volatility in the portfolio overall ... [and] to get our expected rate of return of 7.75%. Absolute return helps us maintain our expectations but lowers our risks.”
- “The Board follows a policy of thoughtfully growing our asset base while protecting against undue risk and losses in any particular investments;” (ii) the “portfolios are diversified on several levels ... though multiple asset classes [that] represent an efficient allocation to achieve overall return and risk characteristics;” (iii) “portfolios within each of the asset classes are diversified through both investment strategies and the selection of individual securities.”
- “ ... new allocations to the ... absolute return buckets [mean] going forward the portfolio is more diversified than ever and represent an efficient allocation to achieve overall return and risk characteristics.
- “We expect the Board’s continued high standard of care for these assets and commitments to diversification to allow the System to meet its long-term goals and objectives.”
- “Based on the continuation of current funding policies by the Board, adequate provisions are being determined for the funding of the actuarial liabilities of the Kentucky Employee Retirement System ... as required by the Kentucky Revised Statutes. The funding rates established by the Board are appropriate for this purpose” ...
- “The relationship of actuarial assets of each fund to the actuarial accrued liabilities,” *i.e.*, “the funding level” should increase over time until it reaches 100%.

- Because of Trustees' "outstanding stewardship," KRS had received an award – "Certificate of Achievement" from the Government Finance Office Association of the United States" for "Excellence in Preparation of its financial reports" and for publishing an "easily readable and efficiently organized document" which satisfies "applicable legal requirements."

265. The Hedge Fund Sellers reviewed and were aware of the contents of KRS Annual Reports and knew that the information was incomplete, false and/or misleading. They also knew that if the true nature and risks of these high-risk, high-fee vehicles were disclosed in the KRS official Annual Reports, an uproar would have resulted, their predatory business model could have been exposed, and the unsuitable "Daniel Boone," "Henry Clay," and "Colonels" investments would have been terminated, costing them millions and millions of dollars a year in fees, and resulted in very harmful publicity. So, they let the deception continue because it served their selfish economic purposes to do so.

266. The Actuarial Defendants reviewed and were aware of the contents of KRS Annual Reports and knew that the information therein regarding the actuarial assumptions and liabilities and investment returns was incomplete, inaccurate and false and misleading. They also knew if the true actuarial facts and liabilities and AARIR were disclosed in the KRS Annual Reports, an uproar would have resulted, independent investigations could have been called for and the Actuarial Defendants could have been terminated, costing them an important client and needed fees and seriously threatening their high volume public pension fund client business model. So, they let the deception continue because it served their selfish economic purposes to do so.

267. The Investment Advisor Defendants reviewed and were aware of the contents of the KRS Annual Reports and knew that the information therein regarding the KRS investment policies, practices, AARIR, KRS’ “Absolute Return” strategies, *i.e.*, the Black Boxes, was incomplete, false and misleading. They also knew if the true nature of KRS’ investment policies and practices, the risk of the AARIR and risks of these high-risk, high-fee vehicles were disclosed in the KRS Annual Reports, an uproar would have resulted, independent investigators could have been called for and the Investor Advisor Defendants could have been fired, costing them an important client and needed fees and seriously threatening their high volume public pension client business model. So, they let the deception continue because it served their selfish economic purposes to do so.

268. The Fiduciary Advisor reviewed was aware of the contents of KRS Annual Reports and knew that the information therein regarding the matters alleged in this Complaint was incomplete, false and misleading. Ice Miller also knew if the true nature and risks of these high-risk, high-fee vehicles and the false actuarial assumptions and estimates were disclosed in the KRS Annual Reports, an uproar would have resulted, an independent investigation could have followed and the Fiduciary Advisor could have been terminated, costing them an important client and needed fees, and seriously threatening their high-volume, public pension fund client driven business model. So, they let the deception continue because it served their selfish economic purposes to do so.



269. The Annual Report Certifier Defendant reviewed and was aware of the contents of KRS Annual Reports and knew that information therein regarding the matters alleged in this Complaint was incomplete, inaccurate and false and misleading. However, the GFOA depends upon the monies it gets for issuing these certifications and endorsements to public pension plans. If it suddenly withdrew or refused to continue giving the annual awards and certification to KRS after the years it had been handing them out in return for dues and fees this would have raised red flags and public inquiry and suspicion and caused an uproar which could have seriously threatened GFOA's volume driven "hand-out-the-certification" business model. So, it let the deception continue because it served its selfish economic purposes to do so.

270. Because they misled rather than tell the truth, Defendants' actions and failures to act alleged in this Complaint are one or more of a civil conspiracy, course of common conduct, and/or a concerted action. The associated false statements created what top Kentucky officials termed a "false sense of security" leading to "smaller than necessary [government] contributions," because instead of complying with the law and telling the truth they "manipulated ... actuarial assumptions" used "unreasonably high investment expectations ... while using "false payroll numbers" – which was "morally negligent and irresponsible conduct."

271. Defendants' actions and failures to act alleged in this Complaint are also a joint enterprise, a course of common conduct, and a concerted action, consisting of an agreement, express or implied, a common purpose, a shared

pecuniary interest, and an equal right to a voice in the control of the enterprise. The false statements made by Defendants created what top Kentucky officials termed a “false sense of security” leading to “smaller than necessary [government] contributions,” because instead of complying with the law and telling the truth they “manipulated ... actuarial assumptions” used “unreasonably high investment expectations ... while using “false payroll numbers” – which was “morally negligent and irresponsible conduct.”

272. KRS, its Pension/Trust Funds and the Commonwealth have sustained and will continue to sustain significant damages, as alleged in COUNT I

273. Defendants’ actions and failures to act made with knowledge of the facts, and Defendants’ negligent actions and failures to act, were all substantial factors in causing the damages alleged herein.

274. As a result of the misconduct alleged herein, these Defendants are liable to KRS and the Commonwealth for damages in an amount to be proven at trial.

#### **COUNT IV**

#### **AGAINST THE OFFICERS, HEDGE FUND SELLERS, ACTUARIAL, FIDUCIARY, AND INVESTMENT ADVISORS AND ANNUAL REPORT CERTIFIER FOR AIDING AND ABETTING BREACHES OF STATUTORY, FIDUCIARY AND OTHER DUTIES**

275. Plaintiffs incorporate by reference all the allegations set forth in the Complaint.

276. Each of the Officers, Hedge Fund Sellers, and the Actuarial, Fiduciary and Investment Advisors knew that Trustees and/or other Defendants owed

fiduciary obligations to KRS.

277. Each of the Officers, Hedge Fund Sellers, and the Actuarial, Fiduciary and Investment Advisors knew that Trustees' conduct and/or other Defendants' conduct as alleged in this Complaint breached those fiduciary duties to KRS.

278. Each of the Officers, Hedge Fund Sellers, and the Actuarial, Fiduciary and Investment Advisors gave Trustees and/or other Defendants substantial assistance or encouragement in effectuating such Trustees' and/or other Defendants' breach of their fiduciary duties, by the actions or failures to act as alleged in this Complaint.

279. The overt acts of Defendants that constitute substantial knowing assistance are the same overt acts alleged as part of Defendants' participation in the scheme, civil conspiracy and concerted common course of conduct and enterprise detailed in COUNT III and throughout this Complaint.

280. Defendants named in this Count had actual knowledge of the existence of Trustees' and Officers' fiduciary duties to KRS, and knowingly provided substantial assistance to Trustees and Officer Defendants in the breaches of their fiduciary duties to KRS.

281. As a direct and proximate result of the Trustee Defendants' breaches of fiduciary duty and of trust, aided and abetted by the other Defendants named in this Count, KRS and the Commonwealth have been damaged.

282. KRS, its Pension/Trust Funds and the Commonwealth have sustained and will continue to sustain significant damages, as alleged in COUNT I

283. As a result of the misconduct alleged herein, these Defendants are liable to KRS and the Commonwealth for damages in an amount to be proven at trial.

**COUNT V**  
**AGAINST THE HEDGE FUND SELLERS, AND THE**  
**ACTUARIAL, FIDUCIARY AND INVESTMENT**  
**ADVISORS FOR PUNITIVE DAMAGES**

284. Plaintiffs incorporate by reference all the allegations set forth in the Complaint.

285. The acts and omissions of each of the Hedge Fund Sellers and the Investment, Actuarial and Fiduciary Advisors constitute willful and wanton conduct, gross negligence, and/or malice and oppression, for which Plaintiffs are entitled to recover punitive damages due to the disregard for the rights of KRS, its Pension Funds, the Commonwealth, and Kentucky's taxpayers.

286. The restrictions on recovery of punitive damages against a principal or employer attempted by the Legislature as set forth in KRS 411.184(3) are unconstitutional and should be determined to be null and void.

287. The Attorney General will be notified of this proceeding.

288. In the alternative, each non-person Defendant authorized, ratified or should have anticipated the acts and omissions of its employees, agents, both actual and ostensible, and servants, all as alleged herein.

289. As direct and proximate result of these Defendants' grossly negligent, willful, reckless wanton conduct, KRS and the Commonwealth are entitled to punitive damages, as determined by the jury.

### **PRAYER FOR RELIEF**

WHEREFORE, Plaintiffs on behalf of and derivatively for the Kentucky Retirement Systems and its Trust Funds and as taxpayers on behalf of the Commonwealth, demand judgment as follows:

1. Declaring that Plaintiffs may maintain this action on behalf of KRS and that Plaintiffs are appropriate representatives for KRS;
2. Declaring that this is a proper taxpayer suit for the taxpayers of Kentucky and Plaintiffs are appropriate representatives for the taxpayers of Kentucky;
3. Declaring that Defendants have breached their respective duties to KRS and to Kentucky's taxpayers;
4. Determining and awarding to KRS and its Pension Funds the damages sustained by them as a result of the violations set forth above from each of the Defendants individually, proportionally and/or jointly and severally, together with interest thereon, as appropriate under Kentucky law;
5. Determining and awarding punitive damages against the Hedge Fund Sellers, Investment, Actuarial and Fiduciary Advisors and each of their principals/officers/employees named as Defendants;
6. Ordering a full and complete accounting of all (i) fees or other payments made to any person in connection with the Black Box funds of hedge funds sold to KRS and managed by KKR/Prisma, Blackstone and PAAMCO; (ii) fees paid to any sub-funds associated with the Black Box funds of hedge funds; (iii) any fee or profit or compensation sharing, splitting or other economic arrangements between the Hedge Fund Sellers, their executives and the Black Box-sub-funds or any third person involved in these absolute return strategies or assets;
7. Issuing injunctive relief removing Cook as a KRS Director, or alternatively, prohibiting him from serving on the Investment Committee, and further directing that any Prisma executives working inside KRS be removed;
8. Granting such relief as later specifically requested or found proper pursuant to Ky. Rev. Stat. §386B.10-010 which provides "Remedies for Breach of Trust," including appointing a Special Fiduciary to oversee and safeguard any net recovery obtained via this action for KRS or Kentucky taxpayers to assure any recovery (after court-awarded

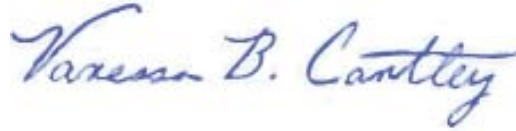
fees/expenses) is used “solely” to benefit KRS and its Pension Funds and the Kentucky taxpayers, as appropriate;

9. Imposing a constructive trust upon and/or ordering disgorgement of all fees or compensation paid to or profits earned by Hedge Fund Sellers, Actuarial, Investment and Fiduciary Advisors and Annual Report Certifier;
10. Award Plaintiffs’ Counsel reasonable fees and expenses, honoring the fee agreements with the named plaintiffs who have brought this action on behalf of and for the behalf of KRS and Kentucky Taxpayers;
11. Awarding each named Plaintiff an appropriate incentive award for having the courage and initiative to bring the action to benefit KRS and Kentucky taxpayers, to be paid out of the recovery;
12. Using the court’s equity power to fashion such relief as is justified and necessary to benefit KRS and/or restore to KRS that to which it is entitled; and
13. Awarding such other legal and equitable relief as the court deems appropriate.



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Ann B. Oldfather, Esquire  
OLDFATHER LAW FIRM  
1330 South Third Street  
Louisville, KY 40208  
Telephone: (502) 637-7200  
Email: aoldfather@oldfather.com



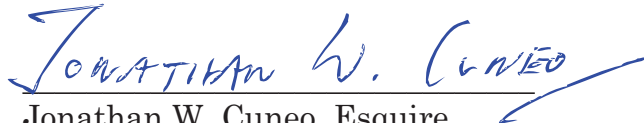
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Vanessa Cantley, Esquire  
Bahe Cook Cantley & Nefzger, PLC  
312 S. 4<sup>th</sup> Street, Suite 601  
Louisville, KY 40202  
Telephone: (502) 565-0035  
Email: vanessa@bccnlaw.com



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Michelle Ciccarelli Lerach, Esquire  
MCL Law Group, APC  
P.O. Box 13519  
La Jolla, CA 92039  
Telephone: (858) 412-3077  
Email: michelle@mcllawgroup.com



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Jonathan W. Cuneo, Esquire  
Monica Miller, Esquire  
David Black, Esquire  
Cuneo Gilbert & LaDuca, LLP  
4725 Wisconsin Avenue, NW  
Suite 200  
Washington, DC 20016  
Telephone: (202) 789-3960  
Email: jonc@cuneolaw.com  
monica@cuneolaw.com  
dblack@cuneolaw.com

***Permission to practice pro hac  
vice will be sought promptly***

## VERIFICATION

***In Re:* Kentucky Employee Retirement Systems Litigation**

I, Jeffrey C. Mayberry, declare that I am a plaintiff in the above-entitled matter. I have read the foregoing Complaint. Based on the advice and investigation of counsel and on information and belief, the allegations therein are true.

December 18, 2017  
DATE

  
JEFFREY C. MAYBERRY

COMMONWEALTH OF KENTUCKY )  
 )  
 ) SS:  
COUNTY OF ~~JEFFERSON~~ <sup>CLARK</sup> )

I, a notary public within the Commonwealth and County aforesaid, do hereby certify that on this 18<sup>th</sup> day of December 2017, personally appeared before me Jeffrey C. Mayberry, to me personally known, who being by me first duly sworn, signed, acknowledged and delivered the foregoing document, as his voluntary act and deed.

My Commission expires: September 25, 202

Notary Public,  
Kentucky at Large

#586439



## VERIFICATION

***In Re:* Kentucky Employee Retirement Systems Litigation**

I, Brandy O. Brown, declare that I am a plaintiff in the above-entitled matter. I have read the foregoing Complaint. Based on the advice and investigation of counsel and on information and belief, the allegations therein are true.

DATE 12.18.17

BRANDY O. BROWN

COMMONWEALTH OF KENTUCKY )  
 )  
 ) SS:  
COUNTY OF ~~JEFFERSON~~ )

I, a notary public within the Commonwealth and County aforesaid, do hereby certify that on this 18 day of December 2017, personally appeared before me Brandy O. Brown, to me personally known, who being by me first duly sworn, signed, acknowledged and delivered the foregoing document, as her voluntary act and deed.

**Notary ID 506255**

My act and deed.

My Commission expires: \_\_\_\_\_

**Notary ID 506255**  
**My Commission Expires**  
**February 26, 2018**

*Burley C. Emanuel*

Notary Public,  
Kentucky at Large

## VERIFICATION

***In Re:* Kentucky Employee Retirement Systems Litigation**

I, Ben Wyman, declare that I am a plaintiff in the above matter. I have read the foregoing Complaint. Based on the advice and investigation of counsel and on information and belief, the allegations therein are true.

DATE \_\_\_\_\_

Print: BEN WYMAN

[illegible]

I, a notary public within the Commonwealth and County aforesaid, do hereby certify that on this \_\_\_\_ day of December 2017, personally appeared before me Ben Wyman to me personally known, who being by me first duly sworn, signed, acknowledged and delivered the foregoing document, as his/her voluntary act and deed.

My Commission expires: June 7 2018

Notary Public,  
Kentucky at Large

