

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

JEFFREY C. MAYBERRY, *et al.*

PLAINTIFFS

**MEMORANDUM IN SUPPORT OF THE TIER 3
PLAINTIFFS' MOTION FOR ACCOUNTING**

KKR & CO., L.P., *et al.*

DEFENDANTS

ELECTRONICALLY FILED

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Tia Taylor, Ashley Hall-Nagy and Bobby Estes (the “Tier 3 Plaintiffs”) respectfully submit this memorandum in support of their motion for accounting.

I. INTRODUCTION

Hedge funds are wrong for public pension plans primarily because of high fees, high risks and lack of transparency about both, and because of their poor net returns.¹ This motion focuses on fees and transparency.

As will be shown below, ***KRS consistently understated the fees paid in connection with its hedge fund investments by as much as \$25-50 million***, or more, each year. The full measure of these fees has ***never been publicly disclosed or accounted for***. Such an accounting is justified simply by the fact that many millions of dollars in public funds have been and will continue to be expended to support this public employee retirement plan; there is, in other words, a need for an accounting independent of any other justification. But it goes beyond that. The fees were so large that they must be viewed as a waste of trust assets, which is perhaps why KRS management has so long kept them hidden. And, the magnitude of the fees, when finally disclosed, will give the lie to the Hedge Fund Sellers’ primary defense — that they performed as advertised and expected.²

The Tier 3 Plaintiffs seek by this motion an order that each of Prisma,

¹ These things are not unrelated. High fees and high levels of risk are related to, and in many instances root causes of, the mediocre net results most hedge funds, including those involved in this case, have turned in over most of the last decade.

² The last detailed manager-by-manager performance report, for February 2017, reflects that Prisma, the longest tenured of the Hedge Fund Sellers, returned a paltry 3.64% annually over the life of the investment. It is likely that the fees paid to Prisma and its underlying managers exceeded this net return, possibly by a lot.

PAAMCO and BAAM³ render and file with the Court an accounting of all management fees, performance fees, expenses and other funds paid to itself or any related persons or entities, and all management fees, performance fees, expenses and other funds paid to each of the underlying hedge funds in which it invested KRS funds.⁴ Each of Prisma, PAAMCO, BAAM and KKR & Co., L.P. should also be made to account for any benefit it received from or related to any of the underlying hedge funds, including but not limited to returns from seeding any such hedge funds.

Accordingly, the Court should grant the Tier 3 Plaintiffs for accounting.

II. ARGUMENT

At the outset, we need first to acknowledge reality — that using the word “fees” to describe the hedge funds’ take is misleading; it’s like a loan shark referring to what he extracts as just “interest.” A study recently published by the Fisher College of Business at Ohio State University⁵ concluded that:

[a]fter including management fees, ***investors collected about 36 cents for each dollar of gross excess return generated by funds on their invested capital. The other 64 cents were paid as management and incentive fees.*** Adding insult to injury, these results are obtained before adjusting fund returns for risk.

³ Prisma Capital Partners, L.P., Pacific Alternative Asset Management Company, LLC, Blackstone Alternative Asset Management, LLC.

⁴ Fee expenses should be provided whether fees were invoiced and paid or were deducted by the managers from the corpus of the investments.

⁵ Itzhak Ben-David, Justin Birru & Andrea Rossi, “The Performance of Hedge Fund Performance Fees,” FISHER COLLEGE OF BUSINESS WORKING PAPER SERIES, June 24, 2020, *downloadable at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3630723.

Ben-David, Birru & Andrea, at 2. In other words, hedge funds — risking their investor clients’ money, not their own — split the profits with the clients two-to-one, with the hedge funds taking the bigger share. Keeping 64% of the profit on someone else’s money is hardly what we think of as “fees”; it’s more like large-scale grift. *See, e.g.,* Mark Hulbert, *Hedge Fund Fees — Whether or Not You Make Money — Are Truly Shocking*, MARKETWATCH, Aug. 22, 2020, available at <https://www.marketwatch.com/story/hedge-fund-fees-whether-or-not-you-make-money-are-truly-shocking-2020-08-21>.

As if that’s not bad enough, the Ohio State study found that ***clients of Funds of Hedge Funds (“FoHFs”) realized less than 9 cents for each dollar of gross returns*** as the report noted that “the ratio of management fees plus incentive fees to gross excess returns is equal to 91.4%, *i.e., almost the entire amount of returns earned on the underlying portfolio of hedge funds is retained by managers as fees.*” Ben-David, Birru & Andrea, at 56-57. Especially in the context of FoHFs, the word “fees” doesn’t come close to describing reality.

Hedge fund managers have traditionally charged “2 and 20” — meaning, 2% of fund assets paid annually as “management fees” (regardless of profit) ***plus*** 20% of gross profits as “incentive” (or “performance”) fees.⁶ But a Fund of Hedge

⁶ Fee percentages may differ slightly from fund to fund, but the management fee + incentive fee structure is ubiquitous. Warren Buffett famously called the 2 and 20 fee system “obscene,” and noted that “two and 20 is going to make a lot of people rich” — just not the investors. *See* <https://www.cnbc.com/2017/02/27/buffett-hedge-funds-fees-border-on-obscene.html>.

Funds, by definition, involves **two layers of managers** — the top-level FoHF manager, plus the managers of the underlying hedge funds in which the FoHF manager invests the client’s funds — and thus **two layers of management fees and two layers of incentive fees.**⁷ This double layer of management fees and incentive fees largely accounts for the finding in the Ohio State study that, to repeat, “**almost the entire amount of returns earned on the underlying portfolio of hedge funds is retained by managers as fees.**”

This brings us to KRS, and the “fees” charged in connection with the three Fund of Hedge Funds manager defendants herein — Prisma, PAAMCO and BAAM. We wish we could tell the Court how much KRS (and indirectly its members) have paid for the double layer of fees in connection with these FoHF investments, but we can’t. These amounts have never been publicly disclosed, as KRS has consistently reported only the top-level fees paid to the FoHF managers, Prisma, PAAMCO and BAAM — but has **never reported the far larger amounts paid as fees to the underlying hedge fund managers.** It is unclear that even high-level KRS insiders knew precisely how much was paid in fees, as it appears they didn’t demand access to this information. They did know the **magnitude** of the actual fee amounts — their consultants told them — but they **persisted in understating total fees by as much as \$25-50 million, or more, per year.** It now is time to force the truth about these fees into the open. This money was paid by Kentucky taxpayers and KRS members; they are entitled to know how

⁷ Fees are paid both at the top level to the FoHF manager (such as, for example, Prisma), and fees are *also* paid to the manager of each of the underlying hedge funds, *i.e.*, the hedge funds in which the FoHF manager invests the client’s (KRS’s) funds.

much of it was wasted.

Here are the known facts. According to documentation prepared by KRS staff and its adviser R.V. Kuhns & Associates, Inc., in August 2011, when the Investment Committee first approved the investment of 10% of pension and insurance trust funds (about \$1.4 billion in the aggregate – an extraordinarily large one-time jump into these exotic investments) with Prisma, PAAMCO and BAAM, the management and incentive fees to be paid to each FoHF and to their underlying hedge funds were as follows:

	Management fees to FoFH managers % of total assets	Management fees to underlying managers % of total assets	Incentive fees to FoFH managers % of profits	Incentive fees to underlying managers % of profits	Total Management Fees annual; off the top % of total assets annually	Total Incentive Fees % of profits annually
Prisma	0.7	1.82	5	19.7	2.52	24.7
PAAMCO	0.75	1.2	5	14.7	1.95	19.7
BAAM	0.5	1.62	10	19.8	2.12	29.8
Average					2.2	24.73

Thus, on average, ***KRS agreed to pay 2.2% of the total amount invested in hedge funds as management fees each year, plus 24.73% of gross profits on top of that.*** Management fees alone were more than \$30 million annually (2.2% of \$1.4 billion), with performance fees on top of that. Yet, KRS never reported anything close. For example, ***KRS reported total hedge fund fees of \$8.4 million*** in its 2014 Comprehensive Annual Financial Report (CAFR). But its ***consultant CMS Benchmarking estimated 2014 hedge fund fees actually totaled \$56.7 million***, meaning ***KRS understated 2014 fees by at least \$48 million.*** And 2014 was no outlier, as the table below shows:⁸

⁸ KRS did not break out Absolute Return-specific expenses in years prior to 2014, and in 2017 and years after, the numbers were mixed with direct hedge fund

Year	Management Fees Reported - Pension	Management Fees Reported - Insurance	Incentive/Other Fees Reported - Pension	Incentive/Other Fees Reported - Insurance	Total Fee Expense Reported	Reference
2014	\$ 6,346,511.00	\$ 2,040,250.00	\$ -	\$ -	\$ 8,386,761.00	2014 CAFR, p. 103
2015	\$ 5,581,543.00	\$ 1,944,631.00	\$ -	\$ -	\$ 7,526,174.00	2015 CAFR, pp. 117 - 118
2016	\$ 6,670,492.00	\$ 2,463,000.00	\$ 565,048.00	\$ 216,523.00	\$ 9,915,063.00	2016 CAFR, pp. 114 - 115

These figures obviously do not include management or incentive fees paid to underlying managers, nor do they include incentive fees paid at the top level (to Prisma, PAAMCO or BAAM) for the first two years. (Notably, the CMS report reflected 2014 top level incentive fees to the FoHF managers of \$10.4 million, on top of the \$8.4 million in management fees they received.)

There is no reason to keep these massive fees a secret from the people paying them. KRS has been instructed in the past to disclose these fees, including the fees to the underlying hedge fund managers, but it hasn't done so. Governor Bevin's Executive Order 2016-340 mandated disclosure of all of these fees in part VIII.A. thereof:

All investment holdings and fees and commissions for each fund administered by the [KRS] Board. ... Investment ... fees and commissions shall be disclosed by each individual manager, including underlying managers in fund [of] funds ... and investment fees and commissions shall include any profit sharing, carried interest, or any other partnership incentive arrangements or agreements.

Disclosure is also mandated by KRS 61.645(19)(i).

But this motion does not seek more disclosure by KRS; it seeks disclosure by the Hedge Fund Sellers themselves. Disclosure is necessary and it is long over-

investments so isolating the FoHF fee expenses was not possible. CMS Benchmarking, however, estimated that KRS paid hedge fund fees of \$31.4 million in 2013 and \$27.7 million in 2012 — but these figures that do not include amounts paid in those years for performance fees at the underlying manager level, as CMS was not provided that information.

due.

KRS 61.650(1)(c) imposes on trustees, officers and other fiduciaries certain duties including the “sole interest” duty, the “exclusive benefit” duty and the duty of “prudence.” Subsection (1)(c)(5) imposes on these fiduciaries the duty to ensure that only expenses “that are appropriate and reasonable” are incurred and paid; put another way, the duty not to incur or pay inappropriate or unreasonable expenses. Expenses that are not “appropriate and reasonable” constitute waste.

The Hedge Fund Sellers were fiduciaries.⁹ They had independent duties to monitor expenses, including fees paid to underlying managers, and to provide full and accurate information on all aspects of the investment dollars entrusted to them, including fees and other expenses. It is therefore entirely appropriate to require them to account for all management fees, performance fees, expenses and other funds paid to itself or any related persons or entities, and all management fees, performance fees, expenses and other funds paid to each of the underlying hedge funds, as well as any benefit they received from or related to any of the underlying hedge funds, including but not limited to returns from seeding any such hedge funds.

This Court has the inherent power to order an accounting. *See, Smothers v. Lewis*, 672 S.W.2d 62, 65 (Ky. 1984); *see also Peter v. Gibson*, 336 S.W.3d 2, 5 (Ky. 2010). Incident to this power, the Court may, and should, order an accounting

⁹ That the Hedge Fund Sellers were fiduciaries is acknowledged by all parties; when and how they became fiduciaries are contested issues. The Tier 3 Plaintiffs believe, and expect to prove, they became common law fiduciaries well before contracts were signed in August 2011. We do not at this point know what position KRS or the Office of the Attorney General will take on these issues.

on the motion of a party or on its own motion. The Court has assumed subject matter jurisdiction, and the facts leave no doubt that (a) the fees paid to the hedge funds (at both levels) were extremely high — well into nine figures — and were material to the overall performance and health of the KRS trust funds, and (b) these fees have never been publicly accounted for or disclosed.

III. CONCLUSION

For the reasons set forth above, the Tier 3 Plaintiffs respectfully urge the Court to grant their motion for accounting. The Tier 3 Plaintiffs also ask that such disclosure be made unrestricted by any protective order, as the amount of fees paid is not a trade secret entitled to any such protection.

Dated: February 15, 2021

Respectfully submitted,

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The above signature certifies that, on February 15, 2021, the foregoing was served via email in accordance with any notice of electronic service or, in the absence of an electronic notification address, via email or mail as indicated below, to:

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