

**Report of the
CalPERS Special Review**

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I. Introduction

Placement agents, in general terms, are intermediaries or middlemen paid by external money managers to help gain access to capital from institutional investors. Over the last 15 or so years, the use of placement agents became somewhat common in the world of private equity and real estate investments, and was not limited to those money managers seeking investments from public pension funds. Where public monies were involved, however, the use of placement agents at times gave rise to various "pay to play" schemes run by well-connected "insiders" and their patrons in government service, as has now been widely reported in the press. The experience of the California Public Employees' Retirement System ("CalPERS"), the nation's largest state pension fund, was apparently no different in this regard than that of a number of other public pension funds. CalPERS announced the outset of a special review of placement agent matters in the fall of 2009 and, while investigating these matters and related activities over the last 18 months, we found that they were not limited to its investment program.

In December 2010, we issued a series of initial recommendations to the CalPERS Board of Administration ("Board") and its executive staff addressing issues raised by these matters and, specifically, by the conduct of those who failed to properly discharge their duties to the institution. The primary purpose of this report is to provide additional information on the need to implement those recommendations, in addition to four others we offer now, and to emphasize the importance of continued diligence on the part of the CalPERS Board and staff in safeguarding the institution from future harm.

II. Background

A. The Special Review

1. Mandate and Scope of the Review

In October 2009, CalPERS publicly announced a special review to be led by Steptoe & Johnson LLP. The purpose of the review was to examine whether the interests of the institution's participants and beneficiaries had been harmed by the use of placement agents or related activities, to pursue remedial measures addressing any such harm, and to make recommendations to prevent future harm. To assist in the review, Steptoe & Johnson retained Daylight Forensic & Advisory LLC, which later became part of Navigant Consulting, Inc. In conducting the review, we were not beholden to any member of CalPERS management or its Board. There were no limitations proposed or accepted on the scope of the review or the work conducted, and the institution was always supportive, including, in particular, the current members of its Board and executive staff.

The work of the special review was guided, in large part, by Article XVI, Section 17 of the California Constitution, as well as Section 20151 of the California Government Code, which provide that the CalPERS Board, its executive officers, and other employees are to discharge their duties solely in the interest of CalPERS participants and their beneficiaries, defraying the reasonable expenses of administering the system, and investing with the care, skill and diligence of a prudent person. For purposes of the special review, we summarized these requirements into two categories: fitness and fees.

With respect to fitness, the review explored the actions of current and former CalPERS executives, staff and Board members as they related primarily to investment

decisions and interactions with external managers and placement agents (or, in some cases, those placement agents and other CalPERS vendors). The review also examined qualitative fitness issues related to the external money managers and investment consultants that serve CalPERS and support its investment process and objectives. We also investigated payments and things of value provided by external managers and their agents to CalPERS staff and Board members.

With respect to fees, the special review focused on whether, during its investment process, CalPERS was misled or made to overpay, resulting in increased expenses and, ultimately, harm to CalPERS' beneficiaries. The special review assessed the apparent arrangements, financial and otherwise, between CalPERS and its external money managers, and between those external money managers and third-party placement agents. The review also examined processes within the investment office as they relate to investment decisions.

As a parallel matter, we have also been assisting CalPERS in evaluating claims and remedies that it may have against those involved in some of these activities. That work remains underway.

We commend the institution for its sustained commitment to these important efforts. The current members of the CalPERS Board and senior staff have taken significant steps to put this chapter behind them and to safeguard the institution. Their courage in undertaking a self-critical review of this nature and scale, and their willingness to implement the many changes needed to address all that was revealed was exemplary, and a standard that other pension funds would do well to follow.

Finally, we note that our review did not extend to the actions of CalPERS executives, staff or Board members as they might relate to other pension funds or other governmental entities (whether in California or beyond). Accordingly, this report does not address such issues and no inferences relating to fitness should be drawn from the omission of such a discussion.

2. Investigative Efforts and Related Matters

Over the course of the last 18 months, the special review requested and received universal and unlimited cooperation from CalPERS and its current employees, and substantial assistance from its external money managers and investment consultants as well as certain placement agents and others. From the roughly 70 million pages of information that we collected from over 400 custodians within CalPERS and beyond, there were many of initial and lasting interest, and that are discussed in this report. In the course of our work, we interviewed over 140 people, many of them more than once as additional information was uncovered. Those interviewed included current and former members of the CalPERS Board, over 100 current and former staff members and executives, including every current member of the investment staff in the CalPERS alternative investment and real estate groups, and a number of external money managers, investment consultants, placement agents and others.

While the special review had substantial access to people and documents, certain information was not available to us. As with any review of this kind, we relied on the voluntary cooperation of the institution, its employees (both current and former), its money managers and consultants, and other third parties. The special review could not compel testimony or the production of documents. While every current CalPERS

employee and Board member cooperated with our requests, other former employees and Board members did not. In particular, several individuals who played substantial roles in some of the events under investigation declined to be interviewed, including former CalPERS Chief Executive Officer Fred Buenrostro and placement agent and former Board member Alfred Villalobos. Both are now defendants in a law enforcement action brought by the California Attorney General in May 2010. Moreover, we did not have access to information and materials in the possession of some other relevant third parties who likewise refused to cooperate. Their information may have affected our views.

The purpose of the special review was not to serve as law enforcement and its mandate did not include determining whether the conduct that was uncovered violated general civil law or merits criminal prosecution. Instead, the findings of the review are based on the duties imposed by the California Constitution, the Public Employees' Retirement Law, and governance and other standards applicable to CalPERS Board and staff members and external managers and investment consultants, all of whom are fiduciaries of the CalPERS portfolio. Those duties impose a much higher standard of conduct than, for example, merely avoiding the commission of a crime. Instead, they require that those serving the pension fund always put the interests of its participants and beneficiaries ahead of personal gain or other interests.

That said, and as has been previously reported, federal and state investigators have been focused for some time on whether civil or criminal laws may have been violated in connection with these placement agent matters and related activities. In the course of our work on behalf of CalPERS, we have had substantial communications with several law enforcement authorities, including: the enforcement staff of the Securities

and Exchange Commission; the California Attorney General's Office; and federal prosecutors and other federal agents in California. We have also been contacted by prosecutors in other jurisdictions, and addressed issues raised by the California Fair Political Practices Commission. These federal and state investigators have made extensive requests for documents and other information, and CalPERS and the special review have complied in every respect, producing millions of pages of materials, providing regular reports and raising new issues as they developed. CalPERS' efforts to assist those authorities have been recognized in many ways, and described by one agency in communications filed in court as "extraordinary and ... critically helpful." For our part, we believe that their pursuit of those who may have harmed CalPERS has also been extraordinary, and that there is more from them to come.

3. Remedial Measures and Recommendations

As noted earlier, we have been assisting CalPERS in evaluating claims and remedies, and that work remains underway. That said, in December 2010, we issued an initial set of twelve recommendations meant to address the leading fitness and fee issues that arose during the course of the special review consistent with our mandate regarding placement agent activities and arrangements. A copy of those recommendations is attached to this report. CalPERS has already taken significant steps in implementing many of them and continues to do so. Those initial recommendations were issued in December, in good part, to inform the incoming legislative session, and have led to a number of related legislative proposals. Another four recommendations are offered in this report.

Over the course of the last year, the special review also took steps to address economic issues raised by placement agent activities and arrangements, leading to various related letter agreements, and to assess whether those responsible for related failings were still associated with or employed by CalPERS. We address each of these again, in further detail below, following our findings.

B. CalPERS and Its Programs

CalPERS administers the largest state pension fund in the United States. Since 1985, the assets of the CalPERS investment portfolio have grown from about \$29 billion to over \$225 billion. The portfolio is held for the benefit of over 1.6 million California public employees, retirees and their families. Based in the California state capital, Sacramento, CalPERS has over 2,300 employees, who are all state civil servants.

CalPERS is governed and overseen by a 13-member Board of Administration. The Board meets monthly and consists of three gubernatorial and legislative appointees, six representatives elected by members, three *ex officio* members (the California State Treasurer, the State Controller, and the Director of the Department of Personnel Administration) and one member designated by the State Personnel Board.

1. Investments

The Investment Committee is one of the most notable of the committees formed by the CalPERS Board and is a committee of the whole, meaning that every member of the Board also sits on that Committee. The Committee reviews investment transactions and investment performance, and also establishes investment policy and strategy.

As set forth in Article XVI, Section 17 of the California Constitution and Section 20151 of the California Government Code, members of the CalPERS Board, its executive

officers and other employees are to discharge their duties solely in the interest of CalPERS participants and their beneficiaries, defraying the reasonable expenses of administering the system and investing with the care, skill and diligence of a prudent person. To fulfill these responsibilities, the CalPERS Board has delegated significant authority regarding investments to the professional staff of the CalPERS investment office. That office and its staff are led by the CalPERS Chief Investment Officer ("CIO"). The investment office includes over 160 professionals responsible for managing the investments used to preserve and grow the capital of the fund.

The CIO oversees the following programs within the CalPERS investment office: Alternative Investment Management ("AIM"), which invests in private equity; Real Estate; Global Equity, which includes the public equity portion of the CalPERS portfolio as well as the Corporate Governance Program and hedge funds; Fixed-Income, which invests in both government and corporate fixed-income securities; and Inflation-Linked Assets, which invests in commodities, infrastructure and forestland projects, and inflation-linked bonds.

Each of these groups is led by a Senior Investment Officer ("SIO") who reports to the CIO. As a function of their delegated authority conferred by the CalPERS Board, the SIOs are directly involved in making many of the investment decisions for CalPERS. The SIOs in each of the programs are supported by several levels of professionals. These include Senior Portfolio Managers, who run much of the day-to-day operations of the various programs and oversee key relationships, Portfolio Managers who are generally responsible for specific investments through the tenure of those investments by CalPERS,

and Investment Officers who perform a range of more basic investment and administrative functions.

While the investment process differs somewhat from program to program, certain observations common to a number of them informed the factual findings and recommendations discussed in this report. For example, several of the programs, including in particular AIM and Real Estate, engage and rely heavily on external money managers to invest the assets of the pension fund. These relationships between external managers and CalPERS are typically structured as limited partnerships wherein CalPERS is a limited partner and the external money manager, or an entity it controls, is the general partner. The external managers charge both management and other related secondary fees (which often are either fixed or a percentage of CalPERS' investment) and incentive fees (which are typically a percentage of the profits earned by the investment). The partnership, including all of the limited partners, generally bears the expenses of the fund.

Each CalPERS investment program is responsible for deploying the assets of the institution in a manner consistent with its fiduciary responsibilities and in line with the asset allocations set by the Investment Committee of the Board. Historically, public equities (that is, publicly-traded securities) have been the largest portion of the CalPERS portfolio. Indeed, the current value of the public equities now held by CalPERS is over half of the value of CalPERS' total portfolio of \$225 billion. After public equities, fixed income is the next largest group of holdings, representing about 20 percent of the portfolio, followed by AIM, Real Estate and Inflation-Linked Assets. Over the last decade, the targeted allocation of the AIM segment of the portfolio has varied between four and 14 percent, with the latter being its current target. During that time, the market

value of the AIM portfolio has ranged from about \$7 billion to a current value of over \$31 billion. Over the same period, the targeted allocation of the Real Estate segment of the portfolio has varied between six and 10 percent, the latter again being its current target. During that time, the market value of the Real Estate portfolio has ranged from roughly \$11 billion to \$21 billion, with a current value of over \$16 billion.

2. Health Benefits

CalPERS is the second largest public purchaser of health care in the nation, behind the federal government, providing benefits to more than 1.3 million public employees, retirees and their families. The program covers state employees by law, and local public agencies and school employers can contract to have CalPERS provide these benefits to their employees (regardless of whether they contract for the retirement program). CalPERS offers three types of health plans: health maintenance organizations ("HMOs"), self-funded preferred provider organizations ("Self-Funded PPOs"), and exclusive provider organizations (limited to members in certain California counties).

The HMOs – Blue Shield of California ("Blue Shield") NetValue, Blue Shield Access+, and Kaiser Permanente ("Kaiser"), among others – provide basic and Supplement to Medicare coverage for members residing in California. There are approximately 900,000 total covered lives in the HMOs combined (basic and Medicare). Prescription drug coverage for the HMOs is provided by Kaiser and Blue Shield.

The Self-Funded PPOs – PERS Select, PERSCare and PERS Choice, among others – provide basic and Supplement to Medicare coverage for participants residing in California and elsewhere. The Self-Funded PPOs are designed for members who want more freedom to choose their providers. Self-Funded PPOs also provide coverage for

members who do not have access to the HMOs that are offered through CalPERS. There are over 340,000 total covered lives in the Self-Funded PPOs combined (basic and Medicare). Medco Health Solutions, Inc. currently provides managed prescription drug benefits to members covered under the Self-Funded PPOs.

III. Fitness Component of Special Review: Illustrative Conduct and Findings

We made a number of observations and recommendations relating to fitness issues in December 2010. We set forth the following illustrative conduct to serve as further foundation for those recommendations, as well as the four additional recommendations regarding fitness issues set forth in Part V of this report, below. While not related to CalPERS' investment program, there was earlier conduct by many of the same former public officials that we believe provides context to many of the placement agent activities that would follow. Accordingly, we begin with an overview of those episodes, subject to the limitations requested by law enforcement authorities.

A. Events of 2004 and 2005, and the Pharmacy Benefit Manager Contract Award

In late May 2004, Alfred Villalobos hosted a meeting at his home in Nevada, a few miles from Lake Tahoe and the California border. Villalobos, a former member of the CalPERS Board of Administration and a former Deputy Mayor of the City of Los Angeles, was joined by David Snow, the Chairman and Chief Executive Officer of Medco Health Solutions, one of the nation's largest pharmacy benefit management ("PBM") companies, and Fred Buenrostro, who was the Chief Executive Officer of CalPERS – a public official – at the time. We will not discuss the reported details of the conversations between Buenrostro, Villalobos and Snow regarding the CalPERS PBM

contract Medco had lost years earlier, in deference to law enforcement authority requests and as we understand that the independent directors of the Medco board are also reviewing these events.

Soon after the May 2004 meeting at the Villalobos home, Medco agreed to retain Villalobos as a consultant and pay him \$4 million. Medco agreed to pay Villalobos and his firm even though, as we understand it, Villalobos had no prior PBM counseling experience, and even though Medco had already hired another consulting firm to assist it in securing the CalPERS contract.

Snow would return to the Villalobos home for another meeting in September 2004, when we understand that Buenrostro and Villalobos were joined by three long-time colleagues: Charles "Chuck" Valdes, Kurato Shimada and Robert "Bob" Carlson. The five men – Villalobos, Buenrostro, Valdes, Shimada and Carlson – had served together on the CalPERS Board ten years earlier, when Buenrostro served as a representative for other California state officials. Valdes, Shimada and Carlson were all public officials and still members of the Board in 2004, and were reportedly introduced to Snow as such at the meeting. There were apparently other meetings over the next year between Snow and some or all of the five men, including what appear to have been private meetings at a Sacramento hotel and another at Medco's Las Vegas pharmacy facility. That November, Buenrostro would also allow Villalobos to host Buenrostro's wedding at the Villalobos home and reportedly pay for the new couple's related expenses.

On October 18, 2005, the nine-member Health Benefits Committee of the CalPERS Board convened at a regularly scheduled meeting to interview finalists and to recommend to the full CalPERS Board the award of the PBM contract. Buenrostro

attended as CalPERS CEO and was joined by Board members Valdes, Carlson and Shimada. Snow spoke on behalf of Medco, whom the CalPERS staff had already ranked as first choice among the candidates. Although it is unclear how it happened, Medco apparently obtained an internal copy of the Health Benefits Committee's background documents. Health Benefits Committee members Valdes and Carlson voted in favor of awarding the contract to Medco, with Valdes making the motion to recommend the award of the PBM contract to Medco. That motion passed and Medco was awarded the contract. (Years later, as has been publicly reported, Valdes would invoke his Fifth Amendment right against self-incrimination when government attorneys questioned him about the PBM contract.) Notably, Board member Shimada also attended the Committee meeting and asked a number of questions of the candidates, even though he was not a Health Benefits Committee member. While there, Shimada asked that his questions be reflected in the official record, along with unspecified others that he said he had planned to ask but that had already been posed by the members of the Health Benefits Committee.

Medco apparently had a check cut for hand-delivery that same day – a \$1 million payment to Villalobos, the final installment of the initial \$4 million agreement. Thereafter, Medco would pay Villalobos a \$20,000 monthly retainer, reportedly until sometime in 2009 when Villalobos' placement agent activities relating to investment managers came under public scrutiny.

B. Connections to Broader Placement Agent Activities

Although the events in 2004 and 2005 surrounding the award of the PBM contract provide a striking example of the manner in which certain business was apparently conducted while Buenrostro was CEO of CalPERS, those events would not come to light

until much later. Some activities – whether relating to CalPERS or other retirement systems – may never come to light. As a former Villalobos associate said, "Do you think we just did this in California? We took the show on the road."

By early 2004, Villalobos had gone on to a certain level of success as a placement agent between private equity and real estate firms looking for investment capital and public pension funds, including CalPERS, that were looking to diversify their investment portfolios. Although some controversy followed Villalobos' involvement with CalPERS' 1997 private equity investment with the Hicks, Muse firm and a 2000 investment with real estate manager CIM, those issues appear to have been largely forgotten by 2004. Villalobos was reportedly paid about \$10 million for those two early deals. But the years after Buenrostro was hired as CalPERS CEO would be far more lucrative for Villalobos, with him and his ARVCO firm earning over \$50 million on CalPERS-related deals alone.

Buenrostro was hired as CEO in 2002 with the support of Valdes, Shimada and Carlson. Although Shimada had taken a three-year break from the Board starting in 1999, at one point working as a placement agent on a deal with Villalobos, at the time of Buenrostro's hiring as CEO, he and Valdes and Carlson were among the most senior members of the CalPERS Board. By 2002, Shimada had served on the Board for 12 years, and would remain until his resignation in August 2010. Valdes served on the CalPERS Board for 25 years, many of them as Chair of its Investment Committee, until December 2009, when he did not seek reelection. Carlson served for 37 years on the Board, including nine as Board President, before his retirement in early 2008. Carlson passed away in September 2010.

Buenrostro was replaced as CEO by the CalPERS Board in May 2008. By early 2009, a number of state prosecutors and federal regulators had begun significant investigations involving private equity firms and their use of placement agents to arrange deals with public pension funds. Recognizing that some of its own external money managers had used these placement agents, CalPERS, in the spring and summer of 2009, instituted new policies regarding placement agents and implemented a comprehensive disclosure program.

The spring of 2009 was not the first time that CalPERS had considered these types of rules. Placement agent disclosure rules had been recommended in February 2007 by CalPERS staff to the CalPERS Board's Benefits and Program Administration Committee ("BPAC") chaired by Shimada. At that time, the California State Teachers' Retirement System ("CalSTRS") was adopting its own placement agent rules. The placement agent rules recommended by CalPERS staff stalled in the BPAC and never came to the CalPERS Investment Committee or full Board for consideration. It seems worth noting that, in 2007, the Investment Committee was still led by Valdes, and it is not known whether he had already been separately consulted on the topic by Shimada or others.

During the summer of 2009, CalPERS sought and obtained information from all of its external money managers regarding their use of placement agents, including the details of those arrangements and the amount of fees the external managers had paid. From these disclosures, CalPERS learned that some placement agents had been paid tens of millions of dollars in placement fees by some of its external managers, and none more than Villalobos and ARVCO, who were reportedly paid more than \$60 million. (The

second highest total was apparently \$19 million, by Donal Murphy and his firms, Tullig chief among them.) CalPERS also discovered that Buenrostro had signed documents purporting to be on behalf of CalPERS, dated both during his tenure as the CEO of CalPERS and shortly after it had ended, stating that CalPERS was aware of millions of dollars in payments that were made to Villalobos. It would be learned later that the documents signed by Buenrostro were necessary for Villalobos to obtain payments of over \$20 million dollars in expected placement agent fees from private equity firm Apollo Global Management, LLC. They apparently made a series of representations to firms like Apollo and Medco, among others, that have since become the subject of law enforcement actions and investigations.

C. Illustrative Conduct and Related Findings

In reviewing information regarding the conduct of scores of CalPERS employees, external money managers and others, the facts regarding those who apparently engaged in activities to the detriment of CalPERS led us back almost invariably to two public officials who served among its leadership at the time: former CalPERS CEO Fred Buenrostro and, to a lesser extent, former CalPERS Board member and Investment Committee Chair Chuck Valdes. Former Board member Kurato Shimada, former CalPERS Senior Investment Officer Leon Shahinian, and a former investment consultant and money manager to CalPERS, Christopher Bower of Pacific Corporate Group, also deserve mention here. Arguably, none of these individuals would have been allowed to serve the institution as long as they did without making some positive contribution over the years. It was not our charge, however, to review the ways, outside the scope of

placement agent and related activities, that their actions may have helped or otherwise harmed the institution.

Again, the mandate of the special review was to determine whether the interests of the system's participants and beneficiaries were harmed through the use of placement agents or related activities, to pursue remedial measures addressing any such harm, and to make recommendations to prevent future harm. Accordingly, while important fitness decisions were made, we have not chronicled here, or attempted to chronicle, every instance of conduct that may have failed to satisfy the high standards expected of CalPERS Board members and staff.

Before proceeding further, we also note that there were many allegations not discussed here that could not be corroborated sufficiently without the ability to compel testimony or the production of documents. Apparently by design, a substantial portion of the conduct at issue occurred away from CalPERS' headquarters at 400 P Street in Sacramento, California. As a result, CalPERS records and the recollections of current CalPERS Board members, management and staff did not play as great a role as one might expect in the investigation of much of this conduct. Further, federal and state investigators have asked us not to disclose certain facts.

That said, we describe below representative segments of the related conduct of Buenrostro, Valdes and the others based on the record available to us. Based on that record, we believe that each of them failed to uphold the duties they owed to CalPERS and its participants and beneficiaries, though they did so in different ways and in varying degrees, as also set forth below.

1. Former Chief Executive Officer Federico ("Fred") Buenrostro

The special review was prompted, in large part, by the discovery in late September 2009 of a set of investor disclosure forms signed by Buenrostro in 2007 and 2008 purportedly acknowledging on behalf of CalPERS substantial placement agent fee payments by Apollo Global Management, a leading CalPERS money manager, to placement agent firm ARVCO in connection with certain Apollo investments made by CalPERS. Our review of those forms, the related transactions and Buenrostro's related conduct have made clear to us that he should not have signed them as he did. Instead, our work suggested that these acts were part of a larger course of conduct by Buenrostro, including his apparent actions involving the PBM contract in 2004 and 2005, that was inconsistent with CalPERS practices and disloyal to its interests. Other examples of Buenrostro's failure to discharge the duties that he owed to the institution during his tenure as CalPERS CEO are discussed below, before detailing his improper execution of those forms.

(a) Pressure Placed on Investment Staff

After becoming CEO, Buenrostro apparently inserted himself in the investment process in a manner inconsistent with prior practice at CalPERS, pressing its investment staff to pursue particular investments without evident regard for their financial merits. For example, Buenrostro reportedly intervened in attempts by Aurora Capital Group to secure new investments from CalPERS, noting to the investment staff the substantial political benefits that might come to CalPERS by supporting an investment firm run by an individual who had just been appointed by the Governor of California to its Public Employee Post-Employment Benefits Commission. (Aurora was also an ARVCO client

and one that Buenrostro reportedly told others he was representing after he left CalPERS to work for ARVCO.) That pressure took the form of Buenrostro requesting regular reports from the senior investment staff on the status of the Aurora proposals, often in his CEO's office, his telling AIM SIO Shahinian that the investment staff was being too hard on Aurora in negotiating terms, and his arranging for meetings with the investment manager directly. (Buenrostro also reportedly told Shahinian that he was being too tough during other negotiations with Apollo, another ARVCO client.) Despite these actions by Buenrostro, the investment staff appears to have evaluated these proposals on their merits independently from his overtures, and we understand that the fund investment that was made has, to date, fared well.

There were other occasions when Buenrostro apparently intervened on behalf of some private equity and real estate managers the CalPERS investment staff would come to call "friends of Fred." Notwithstanding his various efforts relating to the opportunities they offered, the investment staff appears to have evaluated these investments on their own merits and recommended them accordingly. That said, the investment staff did complain about Buenrostro's actions to the Board President, including complaints from two of the then-CIOs and Shahinian. Those complaints were later raised with Buenrostro and became a basis for the Board's efforts to replace him as CEO.

(b) Gifts, Trips and Other Commitments

During the nearly six years he served as CalPERS CEO, between 2002 and 2008, Buenrostro also apparently accepted a variety of undisclosed gifts and other things of value from those with financial interests relating to CalPERS' investment activities. For example, Buenrostro was married in 2004, while serving as CEO, and allowed Villalobos

to not only host the wedding at his home in Nevada, but reportedly also allowed Villalobos to pay for the event as well as lodging nearby for Buenrostro's guests who attended the ceremony. Buenrostro also joined Villalobos, Valdes and another gentleman, a Villalobos associate, on an overseas trip to Dubai, UAE, and to Macau, China. CalPERS paid for Buenrostro's coach class airfare, as well as a per diem meal allowance and lodging expenses he said he incurred in Dubai and Macau. Buenrostro's reimbursement request was approved by one of his deputies at the time, citing his attendance at a conference in Dubai, and totaled over \$5,000. It is not clear why the approval covered his airfare and other expenses for Macau, or why it was approved when two of the used boarding passes he tendered were not his own, but for first class seats in the name of the Villalobos associate who joined Buenrostro, Valdes and Villalobos on the nine-day trip. Questions also remain as to who bore the balance of Buenrostro's costs overseas, for food and entertainment for example, but photographs of activities they engaged in, and of the rooms they stayed in, were found on the hard drive of the CalPERS desktop and laptop computers issued to Buenrostro.

Buenrostro also had another job while he served as CalPERS CEO. As set forth in the California Attorney General's May 2010 complaint against him and others, Buenrostro worked and was paid as a ski instructor at the Squaw Valley Ski Resort in California. He also reportedly gave lessons to a number of ARVCO employees, and was apparently there occasionally on weekdays when he normally would have been expected to be engaged in the discharge of his CEO duties at CalPERS. Finally, after his divorce and over the course of his last two years as CEO, Buenrostro dated a woman employed for part of that time by one of CalPERS' investment managers.

Buenrostro does not appear to have ever disclosed these gifts or recused himself from any CalPERS matters based on any of these apparent relationships.

(c) The Buenrostro Disclosure Forms

As noted earlier, Buenrostro signed eleven documents in 2007 and 2008 purportedly acknowledging on behalf of CalPERS substantial placement agent fee payments by Apollo to ARVCO in connection with certain Apollo investments made by CalPERS. Along with the Medco meetings described above, the substance of these forms and the circumstances in which Buenrostro signed them provide, in our view, another striking example of his failure to discharge his duties of care and loyalty to the institution and the many beneficiaries it serves.

(i) Background

Apollo Global Management is a New York-based private equity and asset management firm, and one of CalPERS' largest and most trusted external managers. Apollo now manages nearly \$5 billion of CalPERS assets, a sum that has grown over time from the first investment made in 1995 through Apollo's performance and through CalPERS investments in ensuing Apollo funds and the management firm itself in years since. In 2006, Apollo hired a new Chief Legal Officer, a senior corporate partner from the New York office of a prominent California law firm. It was reportedly his view, based on related federal securities law provisions, that if Apollo paid placement agent fees in connection with raising one of its funds, those payments should be disclosed by the adviser (Apollo) not only to the fund (itself another Apollo entity) but also to the investors in the fund, including CalPERS and other institutions. A template of the related disclosure form that Apollo required to complete its files and to pay the placement agent

was attached to its engagement letter with the placement agent firm in question, ARVCO. We understand that Apollo enforced this requirement and refused to pay a fee when ARVCO was unable to provide a disclosure form signed by another Apollo investor, a different California state trust fund.

In August 2007, shortly before the closing of Apollo Investment Fund VII, CalPERS was contacted by ARVCO with regard to such a form. CalPERS had completed its diligence on that new fund some time before, and had already executed a subscription agreement and other investment documents sent to Apollo. On August 23, Carrissa Villalobos, a daughter of Alfred Villalobos who acted as general counsel of ARVCO, sent an email message to Joncarlo Mark, a Senior Portfolio Manager in the AIM or alternative investment program group of the CalPERS investment office, asking that Mark sign an attached one-page investor disclosure form stating that CalPERS was aware of the placement agent fees paid to ARVCO in connection with its investment in the new Apollo fund, among other representations. Later that day, after consulting with the lead AIM program attorney in the CalPERS legal office and outside counsel, a partner in the Los Angeles office of another prominent California law firm, Mark replied via email to Ms. Villalobos that he and CalPERS would not sign the form. Both Mark and his supervisor, Shahinian, signed declarations in support of the California Attorney General's enforcement action against Buenrostro and Villalobos stating that they had never seen such a form before and did not believe it was appropriate for anyone at CalPERS to execute. Mark's email reply to Ms. Villalobos noted that if she had questions she should direct them to the attorney in the CalPERS legal office. We understand that Ms. Villalobos did call the attorney shortly thereafter and was told again that CalPERS

would not make the representations in the form or execute it. The CalPERS investment office, and legal office, apparently never heard from ARVCO again with regard to such a form.

Buenrostro, however, did sign the one-page form, months later, along with eight others like it for various CalPERS investments made with Apollo in 2007 and 2008, after Apollo's lawyers apparently pressed ARVCO for them. Buenrostro also signed two other forms tendered to Apollo for a fund that was apparently never offered to CalPERS.

While not a member of the investment staff, Buenrostro signed them as CalPERS Chief Executive Officer – an act by the CEO inconsistent with CalPERS investment practice, among other things. Each of the one-page forms that Buenrostro signed is printed on a semblance of CalPERS letterhead, albeit an unauthorized one, and makes representations regarding placement agent fees and related deal documents that are either demonstrably false or sufficiently suspect that we believe someone attempting to act on an informed basis and in good faith would not have executed them on behalf of the pension fund without first consulting with those directly involved in the investments. Based on our work and the available record, it does not appear that Buenrostro ever consulted with the CalPERS investment staff on the deals, or with anyone at Apollo, regarding these forms. ARVCO provided the signed forms to Apollo and was reportedly paid more than \$20 million in placement agent fees by Apollo in connection with these investments.

We understand that those payments to ARVCO would not have been made without the forms that Buenrostro signed. Apollo accepted the Buenrostro signatures as CEO as sufficient, even two dated after his tenure as CEO had ended, and neither Apollo nor the CalPERS investment staff apparently ever raised the issue of the form directly

with the other, missing an opportunity to reveal these improprieties as they were occurring. Apollo has since filed a proof of claim against ARVCO and Villalobos in their pending bankruptcy proceedings in Nevada, consistent with the law enforcement claims made by the California Attorney General regarding misrepresentations made to Apollo and others by ARVCO and Villalobos.

One of the last of the disclosure forms that Buenrostro signed, dated May 20, 2008, is particularly troubling and merits detailed review here, in terms of both surrounding events and its contents and other characteristics.

(ii) Events Surrounding the May 20, 2008 Buenrostro Disclosure Form

By early 2008, Buenrostro's performance as CEO was apparently such that his ongoing tenure at CalPERS was in doubt. The Board had expressed its concerns to Buenrostro in various meetings by that time and Board President Rob Feckner sent him a memorandum via email message on March 20, 2008 reiterating them. While the Feckner memorandum discussed sensitive and confidential issues about Buenrostro and the pension fund, Buenrostro forwarded it via email to ARVCO. We understand that Buenrostro also solicited comments from Villalobos via email on a draft of his replies to the Board and its concerns. We believe that these acts – Buenrostro's circulation of confidential state pension fund information and materials outside the institution – represent, at a minimum, lapses in judgment that rendered him unfit to serve as CalPERS CEO.

During the course of the special review, a number of individuals close to Buenrostro came forward with information relevant to these exchanges and his related conduct more generally, including his ex-wife and a woman he dated after his divorce.

Both called him a "puppet" of Villalobos, a striking observation by two of the women closest to Buenrostro during his tenure as CEO. His ex-wife also provided declarations supporting the state law enforcement action against him, stating that, while Buenrostro was still CalPERS CEO, Villalobos made him a standing offer of employment at ARVCO that would include his receipt of a condominium near Lake Tahoe in Nevada, near the Villalobos home – an offer that reportedly included a \$300,000 annual salary and that was reiterated to Buenrostro when he complained to Villalobos about the CalPERS Board. As an aside, we understand that Buenrostro became employed by ARVCO as of July 1, 2008, and that a Lake Tahoe condominium was later sold or transferred to him by Villalobos. Apart from this offer, there is no record among those available that Buenrostro seriously entertained any other offer of employment in the months before his departure, or that he recused himself from any matter at CalPERS while searching for his next job.

By April 2008, outsiders were contacting Buenrostro about his position, one writing via email that he had it from a connected source that the Board may be out to get Buenrostro. Later that month, press accounts began to speculate about his forthcoming departure from the CEO post. Those predictions proved true, and Buenrostro was replaced as CEO on Monday, May 12, 2008. CalPERS issued a press release that day, also noting that Kenneth Marzion had been designated interim CEO. By agreement, Buenrostro's departure was called a retirement and he remained on the CalPERS payroll until the end of that fiscal year, June 30, 2008. Buenrostro was informed via email on May 12 that the Board had rescinded his CEO delegation earlier that day, and Buenrostro acknowledged his receipt of the note via reply email the following day.

A number of CalPERS employees recall Buenrostro leaving the office early on Friday, May 9, and never returning to CalPERS again or at least never during business hours before Friday, June 27. He was removed from the CalPERS payroll on Monday, June 30. While employee recollections and CalPERS identification badge entry records do not allow for a perfect reconstruction, Buenrostro only appears to have made two brief visits to the office after May 9: on Sunday, May 11, at 8:31 p.m., for nine minutes, and on Friday, June 27, at 4:13 p.m., for 20 minutes. As it turns out, on his last full day in the office as CEO, May 8, Buenrostro was interviewed by outside counsel, lawyers from a prominent California firm, in connection with an internal matter. During that discussion, Buenrostro reportedly volunteered that his executive office ran very separately from the CalPERS investment office, adding that his involvement in investment matters was limited to his suggestions that the office consider certain categorical investment priorities that interested him (environmental, diversity and healthcare, for example) and attending related "meet and greet" meetings and calls, and that he did not make investment-related decisions.

Consistent with a new CalPERS policy at the time regarding executive departures, the hard drives of the CalPERS desktop and laptop computers issued to Buenrostro were secured upon his departure from public service. Among the documents on his laptop was a completed passport visa application, dated June 7, 2008, for a trip Buenrostro apparently planned to take to India in July. Buenrostro was still a CalPERS employee, and on the California state payroll, at the time. The completed application lists Buenrostro's employment status as retired and the purpose of his trip as business for ARVCO.

In the midst of all this, Buenrostro signed his name on a disclosure form that listed his title as CalPERS Chief Executive Officer and was dated May 20, 2008, more than a week after he had been replaced as CEO and his delegation rescinded. We understand that the document was later tendered to Apollo by ARVCO and, like the others Buenrostro signed, there is no indication that a copy was ever in CalPERS' investment files. Considered in the context of surrounding events, Buenrostro's execution of this May 20 disclosure form: (1) contravened the prior views of the CalPERS investment and legal offices and outside counsel, which he apparently made no attempt to solicit; (2) was inconsistent with Buenrostro's apparent statements on May 8 about his involvement in CalPERS investment matters; and (3) resulted in a direct economic benefit to Buenrostro's future employer, ARVCO.

(iii) Other Issues regarding the Form and Contents of the May 20, 2008 Buenrostro Disclosure Form

Incidental to the circumstances surrounding that May 20, 2008 Buenrostro form, the contents and physical features of the document he signed are sufficiently suspect that we do not believe a public servant acting on an informed basis and in good faith would or should have executed it. The disclosure form discusses the Apollo Credit Opportunity Fund, and Buenrostro represented, among other things, that CalPERS had received a copy of an Apollo private placement memorandum for that fund. As Apollo and the CalPERS investment office can both confirm, there was no private placement memorandum for that fund. Further, the proposed fee to be paid is listed as between 0.5% and 4.0% of the CalPERS \$1 billion commitment, or between \$5 million and \$40 million, a potential eight-fold spread in the fee that would have demanded further inquiry by a responsible fiduciary before execution. There are also various typographical and

language errors that one would not expect to see on an easily-reviewed, one-page form purportedly relating to a \$1 billion investment transaction.

Finally, the physical features of that May 20, 2008 Buenrostro document, among others, are also cause for considerable concern. The document was apparently printed on a color printer unlike those in the general population at CalPERS and its executive office in particular. Further, the document bears an odd form of the CalPERS logo on the upper right-hand side of the page and has no other letterhead text. CalPERS' official letterhead in use in 2008 and earlier displayed the CalPERS logo in a crisper form on the upper left-hand side of the page along with the name and address of the CalPERS office sending it (*e.g.*, the investment office, legal office or executive office). Indeed, the mere presence of the CalPERS logo on such a form is suspect. The disclosure form was one apparently created by and for Apollo in connection with its engagement of ARVCO. The form Carrissa Villalobos sent to Joncarlo Mark in 2007 had no logo nor any request that it be placed on CalPERS letterhead. We have also since seen other versions of the form bearing an ARVCO logo and address. One cannot help but believe that the addition of a CalPERS logo, in whatever form available, reflects some attempt at the time to enhance the apparent authenticity of the document.

Buenrostro signed ten other forms like this one in 2007 and 2008 with other notable physical features that we have not discussed here in deference to requests from law enforcement authorities, whose investigations are ongoing. On that score, the original forms that Buenrostro signed have been secured, and are in the possession of federal prosecutors and their agents for safekeeping and forensic testing. Likewise, the Buenrostro hard drives are also now in the possession of those authorities.

2. Former Board Member Charles ("Chuck") Valdes

Charles Valdes was an elected member of the CalPERS Board of Administration until December 2009, when he did not seek re-election. He left shortly after the outset of the special review and an abbreviated interview with us. That December, Valdes was also fined \$12,500 by the California Fair Political Practices Commission following an investigation of illegal contributions to his prior re-election campaign by certain ARVCO employees and an ARVCO affiliate. Valdes had served on the Board for 25 years and in a number of leadership positions including, notably, as Chair of the Board's Investment Committee from 1988 through 1999, and again from 2005 through 2007, and as a member of its Health Benefits Committee. Outside of CalPERS, Valdes once served as an attorney with CalTrans, the California Department of Transportation.

As discussed earlier, and notwithstanding his duties to CalPERS, Valdes appeared at the Villalobos home in Nevada and met with Villalobos, Buenrostro and Medco CEO Snow, among others, in 2004, where they discussed CalPERS business among them, including Medco's relationship with CalPERS. Valdes never appears to have made any attempt to disclose these discussions to the full Board or to recuse himself from Medco's consideration for the PBM contract. Instead, during the PBM candidate interviews conducted by the Health Benefits Committee of the Board, Valdes was the Committee member who made the motion to award the contract to Medco.

Valdes also brought pressure to bear in his own way on the CalPERS investment staff with regard to investments associated with ARVCO. For example, in September 2000, he was threatened with being ruled out of order during an Investment Committee meeting relating to a proposed investment with CIM Group, a leading real estate

investment manager. The then Chair of the Investment Committee faulted Valdes for having accused the CalPERS staff and an outside investment consultant at Pension Consulting Alliance, Inc. of dishonesty when they suggested a reduced investment amount and an alternative investment structure. An investment ultimately was made, and ARVCO was paid over \$9 million in fees.

Valdes also reportedly joined Buenrostro and Villalobos at casinos local to the Villalobos home, where he and others are said to have accepted hundreds of dollars in playing chips from Villalobos while there. We understand that the chips were offered to Valdes, Buenrostro's wife at the time, and others to allow Villalobos more time to speak with Buenrostro alone. Valdes does not appear to have ever reported these activities or gifts to the full Board or on his related disclosure forms.

During his time on the Board, Valdes apparently suffered a series of financial setbacks leading to personal bankruptcy filings in 1991 and 1997, and, following action by a credit card company, an almost \$18,000 judgment lien against him in August 2006. These problems are notable in that they also reportedly prevented Valdes from being issued a CalPERS credit card, like other Board members, making his CalPERS-related travel arrangements more complex and cumbersome for the CalPERS travel and Board administrative staff, who often had to call ahead to pre-pay his hotel rooms or issue him a travel advance by check. These personal financial setbacks may also have made him susceptible to influence by those with business interests involving CalPERS.

In addition to the Medco and casino meetings noted above, Valdes traveled to Dubai and Macau in November 2006 with Buenrostro, Villalobos and a Villalobos associate. While it is not known whether Valdes attended the Dubai conference that

Buenrostro mentioned on his travel reimbursement form, photos of Valdes and others in Dubai and Macau were found on the desktop and laptop computers CalPERS issued to Buenrostro. Valdes did obtain a \$6,000 travel advance from CalPERS for the trip, citing the Dubai conference, but never submitted a reimbursement form to substantiate that payment. CalPERS ultimately deducted the \$6,000 from subsequent reimbursement requests that Valdes made.

Valdes publicly stated in late 2009 that ARVCO made and paid for these travel arrangements and that Valdes reimbursed ARVCO more than \$23,000 for the trip. In his bankruptcy proceedings, Villalobos filed certain financial records, including an apparent invoice from ARVCO, dated December 12, 2006, in the amount of \$23,630.98 purportedly sent to Valdes for the costs of the Dubai/Macau trip. Those records included receipts for first-class airfare and hotel charges overseas. After the outset of the special review in the fall of 2009, and in response to press requests, Valdes produced to the requesting newspaper a redacted personal check that he claimed reflected his reimbursement to ARVCO. We also obtained a copy of that redacted check. It is dated December 1, 2006, 11 days before the ARVCO invoice. The redactions on the personal check make it impossible to confirm its legitimacy or the source of the underlying funds. It is also not known if Valdes had satisfied the almost \$18,000 judgment lien against him, entered less than four months earlier. The California Attorney General complaint against ARVCO, Villalobos and Buenrostro stated that Valdes made cash deposits of \$9,000 on November 30, 2006 and \$5,000 on December 2, 2006, reportedly to help clear the December 1 check to ARVCO. The mismatches in dates between the redacted Valdes check, the reported cash deposits and the ARVCO invoice are causes for concern that

could not be resolved based on the information available to us. Despite being a sitting member of the Board at the time, Valdes refused to answer questions regarding, among other things, the sources of funds for these checks.

Valdes and others at CalPERS were also invited to attend the Academy Awards ceremony in Los Angeles a number of times. The invitations came from CalPERS real estate investment manager CIM. One of the CIM funds in which CalPERS invests owns the Kodak Theatre where the awards ceremony is held, and CIM saw fit to extend invitations from those it received from the theater's property manager to certain individuals at CalPERS, including Valdes. Valdes apparently attended the event at least twice, in 2005 and 2006, and, when accepting the invitations, he reportedly directed CIM to work with ARVCO in making his related travel arrangements. We understand that an ARVCO employee accompanied Valdes to a dinner before the event and tendered the credit card used to pay for a hotel room for Valdes. CIM did not report any of this conduct to CalPERS at the time. It is not clear whether Valdes reimbursed ARVCO, CIM or anyone else for the entirety of his expenses associated with these trips. On his annual CalPERS Statement of Economic Interests filings, however, Valdes did not report receiving any gifts in 2005 or 2006.

Valdes also appears to have received gifts from other individuals and entities with business interests involving CalPERS, including other money managers and placement agents. For example, Valdes attended overseas conferences where the airfare was provided by certain external managers and attended dinners with money managers and placement agents. Valdes was also offered assistance from a placement agent in securing an audience with the Pope on a trip to the Vatican that Valdes apparently was to take with

his father. Based on the available record, it is not clear whether Valdes or any of his family members took that trip or whether anything of value was ultimately provided to Valdes in connection with the offer. On another occasion, at a time when Valdes' CalPERS travel privileges had been suspended because of outstanding receipts, a consultant working for CalPERS attempted to provide airfare for Valdes so he could attend a conference in London. Based on available information, we could not confirm whether Valdes accepted that offer and took the trip in question.

As these episodes suggest, during his tenure on the Board, Valdes showed little apparent regard for CalPERS travel and expense reimbursement policies. Valdes often went months without submitting the documentation needed to reconcile his CalPERS travel account. When he did submit materials, they were tendered in unorganized boxes of stray receipts, among other related and unrelated records, leaving to CalPERS staff the task of sorting through them. As noted earlier, at one point, his travel privileges were suspended as a means of compelling him to bring his expense reconciliations in order.

While we express no opinion on whether Valdes violated criminal or general civil laws, a matter we leave to law enforcement authorities, we do believe that his actions were inconsistent with the standards of care and loyalty expected of CalPERS Board members and public servants entrusted to protect pension fund assets. Further, we find it remarkable, in view of his ongoing financial problems and the obvious difficulties they posed to CalPERS' travel and other staff, that Valdes was permitted to travel as he did on behalf of CalPERS beyond attending its Board meetings and, more important, that he was allowed to continue serving as Chair of the Investment Committee of the Board. Action on either of these points, or at least further inquiry, might have helped expose his

association with many now apparent improprieties well before the outset of the special review. We note that the CalPERS Board has since adopted more stringent censure policies regarding its members.

3. Former Board Member Kurato Shimada

Kurato Shimada was an elected member of the Board who served from 1987 until 1999 and again from 2002 until 2010. Like others described above, we believe that Shimada allowed his relationship with a placement agent to interfere with his duties to CalPERS. In 2000, a year after leaving the CalPERS Board, Shimada helped Villalobos and ARVCO market an investment offered by CIM to CalPERS and was paid by Villalobos for his work. After rejoining the Board in 2002, Shimada continued to interact with ARVCO and Villalobos. Shimada attended at least one meeting at the Villalobos home with Buenrostro, Valdes and Carlson where they were joined by Medco CEO Snow, and CalPERS business was discussed. Shimada also reportedly joined Buenrostro, Valdes and others on visits to casinos local to the Villalobos home and has, at different times, denied and acknowledged accepting playing chips from Villalobos while there. Shimada does not appear to have made any attempt to disclose these activities to the full Board or the Health Benefits Committee prior to its award of the PBM contract to Medco or at any other time before his resignation. Shimada also attended the 2006 Academy Awards as a guest of CIM and, like Valdes, the arrangements for his trip were apparently made for him by ARVCO.

In July 2010, Shimada was called by Villalobos as a witness in the bankruptcy proceedings Villalobos commenced in the wake of the California Attorney General's enforcement action against Villalobos. After his deposition, Shimada made numerous

substantive changes to his answers on issues relating to his conduct while he served as a member of the CalPERS Board. For example, Shimada testified that he received no help in paying for his trip to the Academy Awards and that no one from ARVCO was present at the event. Four weeks later, Shimada corrected his deposition transcript to state that he did receive help paying for the trip, and that an ARVCO representative was there to make sure Shimada got his tickets. Shimada also testified that he had never been to the Villalobos home in Nevada or ever been alone with Villalobos other than two golf outings, but later corrected his transcript to reflect that he had been to the Villalobos home a number of times and been alone with Villalobos on numerous other occasions. During his deposition, Shimada was also asked by the Deputy Attorney General when he had last spoken with Valdes, who was also deposed in those proceedings and refused to provide substantive testimony. In July, Shimada testified that it had been three months since they had spoken and only to discuss Valdes' health. Shimada later corrected his deposition transcript to state that he had spoken to Valdes only ten days before the deposition and that they had discussed Shimada's deposition subpoena.

These testimony transcript changes reveal that many of Shimada's initial answers under oath, and made while still serving as a public pension fund official, were misleading at best. And because Shimada offered these corrections only after the deposition was over, there was no opportunity for the Deputy Attorney General or others to explore these responses or the full extent of the ongoing relationships between Shimada, Villalobos and others. Shortly thereafter, Shimada was given another opportunity to explain himself when he was called before federal investigators, but Shimada reportedly refused to substantively answer any questions regarding his conduct

as a CalPERS Board member or related issues during the time he was expected to be serving the institution.

Shimada resigned from the Board on August 31, 2010. We believe that he made the right decision as, in our view, his involvement in these activities and his repeated failure to disclose them were inconsistent with his duties to CalPERS.

4. Former AIM Senior Investment Officer Leon Shahinian

Between July 2004 and May 2010, Leon Shahinian was the Senior Investment Officer in charge of the CalPERS AIM or private equity program, with oversight of over \$20 billion of committed capital. Shahinian joined the CalPERS investment office in 1998 as an Investment Officer and was promoted steadily thereafter to AIM SIO, one of the most highly-compensated positions in California public service. In 2006 and 2007, for example, Shahinian was paid over \$500,000 each year.

Shahinian was a member of the AIM team for the entire time Buenrostro was CEO. For most of Buenrostro's tenure, Shahinian served as SIO for the AIM program and, like his staff, apparently resisted repeated attempts by Buenrostro to improperly influence the investment process as noted above. Shahinian also made efforts to address these issues, raising his complaints about Buenrostro with the CalPERS Board President, and telling Apollo's founder that it was unnecessary for Apollo to engage Villalobos given the strong and long-standing investment relationship between CalPERS and Apollo.

After years of apparently diligent performance for CalPERS, however, Shahinian seemed to lose his way. In May 2007, Apollo Global Management and CalPERS were in negotiations regarding CalPERS purchasing a stake in the Apollo management company.

Shahinian was among the lead staff members at CalPERS responsible for assessing the proposed investment and, despite its long-standing relationship with CalPERS, Apollo retained Villalobos as a placement agent to market this new investment to the pension fund.

Early that same month in 2007, Villalobos contacted Shahinian and invited him to a black-tie event at the Museum of Modern Art ("MOMA") in New York honoring Apollo founder Leon Black and his wife. Shahinian accepted the invitation and rented a tuxedo for the event. He apparently made no effort to book a commercial flight to New York, choosing instead to accept Villalobos' offer to fly with him there by private jet. Based on available records, it does not appear that Shahinian made any hotel arrangements for his night in New York, apparently leaving those to Villalobos as well. Telephone records from the two-bedroom hotel suite that Villalobos used that night reflect two calls to Shahinian's home, a five-minute call at 5:38 p.m. and a 10-minute call at 10:21 p.m., suggesting that Shahinian spent time there before and after the MOMA event. Villalobos and ARVCO apparently paid for all of the travel arrangements for the trip, and later billed Apollo over \$8,000 for the suite and related hotel charges, over \$1,500 in car service fees, and over \$50,000 for the use of the jet. (Villalobos was later reimbursed for these costs, and paid a placement agent fee of over \$13 million after the CalPERS investment was made.)

There is information suggesting that there was a diligence meeting about the proposed investment among Shahinian, Villalobos and Black at Apollo's offices on the afternoon of the May 2007 MOMA event. When Shahinian was deposed in July 2010 in the Villalobos bankruptcy proceedings, however, he said that he did not recall such a

meeting but that his trip to New York was for business and to further and enhance the existing investment relationship between CalPERS and Apollo given the proposed investment. Nonetheless, Shahinian submitted a personal leave request form at CalPERS for May 15, 2007, the day of the MOMA event, on May 23, 2007, eight days after his trip to New York.

After the trip, Shahinian also accepted three bottles of wine and champagne from Villalobos, including one said to have been served at the event. Shahinian reportedly returned two bottles to Villalobos more than two years later, shortly after the outset of the special review.

One month after his trip to New York, Shahinian made a presentation to the Investment Committee of the Board regarding the proposed investment in Apollo. While these dealings do not appear to have altered the analysis that he and the investment staff performed on the proposed transaction, Shahinian's failure to inform his CIO and the Board of his activities in New York before their approval of the investment was a disappointing error in judgment – an error as grave as his decision to accept the invitation. Further, Shahinian's failure to consider the appearances that would be created by his traveling as he did and by attending the event, as well as his failure to inquire about who would or did pay for it, were not in keeping with the duties of care and loyalty that he owed CalPERS. Simply put, and based on his prior performance, he should have known better.

Shahinian was placed on administrative leave by CalPERS in early May 2010 after many of these facts appeared in the California Attorney General's enforcement action against Buenrostro and Villalobos amidst allegations that Villalobos had attempted

to bribe Shahinian (in contrast to the leading claims in the enforcement action that Villalobos had indeed bribed Buenrostro and Valdes to the detriment of CalPERS). Shahinian accepted other gifts from another placement agent late in his tenure at CalPERS and, rather than face a civil service hearing on these issues, among others, he tendered his resignation to CalPERS in late August 2010. His departure was, in our view, the right result. As we observed in our recommendations in December 2010, however, it could have been achieved more swiftly, but for the constraints of certain general civil service rules, and should not have cost CalPERS the substantial added sum of his compensation over general state civil service pay scales – over \$100,000 during the pendency of his administrative leave before his resignation.

5. Christopher Bower of Pacific Corporate Group ("PCG")

During the review, we also considered whether CalPERS' investment consultants and external managers had acted in a manner consistent with the best interests of the institution and its beneficiaries. Some apparently strayed from this high standard, and CalPERS either terminated its relationships with them or limited their relationships in other ways. Among them were Christopher Bower and his firm, PCG.

PCG had worked for CalPERS for many years, as both an investment consultant providing opinions on the prudence of proposed investments and tracking their performance, and as a money manager for CalPERS assets. PCG eventually held over \$2 billion in fund assets for investment and was one of the very few firms that did so while also serving as an investment consultant – multiple fiduciary roles that we believe are too much, in terms of conflicts, to ask of any firm. In making our initial recommendations last December, we noted that CalPERS must be able to rely on the independent judgment

of its investment consultants. That independence may appear compromised if a consultant is asked to assess the ongoing (and perhaps poor) performance of an investment that it had deemed prudent in an earlier opinion issued to CalPERS, when the investment was first under consideration. That concern becomes even more acute where the consultant in question is asked to opine on the terms and conditions of a proposed private equity or similar investment and, given its concurrent status as a money manager, could be viewed as a competitor to the proposed investment manager or as one with an economic stake in seeing that CalPERS does not move the market or even the terms of the particular deal in question to achieve lower investment costs for CalPERS. As an independent fiduciary, the consultant must be free, and appear free, to advise CalPERS to push toward quality investments with lower costs, rather than be seen as perhaps overly mindful of its concomitant profit-seeking interests as a money manager.

With specific regard to Bower, who led PCG during the years it served CalPERS, it now seems that his connections to Villalobos may have prevented him from acting in the best interests of CalPERS. Bower had employed Villalobos and ARVCO to assist PCG in its fundraising efforts, as Bower and PCG set forth in a June 2007 letter to CalPERS. The letter notes that PCG and ARVCO had a long-standing professional relationship, including ARVCO's work on behalf of PCG targeting investors other than CalPERS. The letter was offered to CalPERS to explain why PCG should be allowed to continue serving as an independent investment consultant for CalPERS as the pension fund considered investments in funds that had retained ARVCO or Villalobos as a placement agent. Bower explained that PCG did not use ARVCO as a placement agent to pursue investments from CalPERS, noting that PCG's "contracts specifically exclude the

Villalobos companies from sharing in any fees or commissions with respect to investments made by CalPERS." That was not always true. In February 2006, PCG had retained ARVCO affiliate Capital Formation Partners to pursue a strategic partnering investment from CalPERS in PCG Holdings, PCG's parent company. That opportunity was still being considered by CalPERS in June 2007, when Bower sent CalPERS his letter, and was not rejected until over six months later.

Concerns regarding Bower and PCG extended beyond their connection to Villalobos. PCG ran afoul of law enforcement authorities in New York. In July 2009, PCG settled charges with the New York Attorney General after it was alleged that an investment group that included PCG made bribes to officials at the New York State Common Retirement Fund. At least one PCG executive reportedly knew of these payments. Bower is also now in litigation with a former PCG executive who claims that Bower misled CalPERS, among other PCG clients.

Further, the independence of PCG's investment opinions has also been called into question by at least one other former PCG employee, who suggested that Bower and his firm would not oppose investments in funds for which Villalobos was hired as a placement agent – a troubling claim that we could not confirm based on available information and Bower's unavailability to us.

PCG's service as an investment consultant was allowed to lapse at the end of June 2010 and its service as money manager was terminated in October 2010, when the CalPERS assets under its management were moved elsewhere. Those decisions by CalPERS were correct, in our view, because these entanglements taken together

undermined the ability of Bower and PCG to continue serving CalPERS and its beneficiaries.

IV. Fee Component of Special Review: Observations and Findings

At over \$800 million a year, external money management fees constitute the largest recurring expense for CalPERS. As we said in December, many of the abuses relating to placement agent arrangements were, in a sense, a symptom of a larger problem relating to the prudence of certain external manager fees paid by CalPERS. It was and remains, in the first instance, the responsibility of CalPERS staff and its investment consultants to negotiate and monitor these types of fees. At least in hindsight, the excessive nature of some of the fees paid by CalPERS created an environment in which external managers were willing and able to pay placement agent fees at a level that bore little or no relationship to the services apparently provided by the placement agents. Moreover, the involvement of placement agents apparently led to pressure to accept external manager fees that may have been higher than they should have been.

Although the fitness component of our review was important in helping to avoid future harm to the institution (by, among other things, highlighting improper conduct to discourage it from happening again), addressing the economic issues raised by placement agent-related activities is essential to making participants and beneficiaries whole for the harm that was previously caused. While CalPERS did not have contracts with the placement agents involved with its external money managers, those external managers did. There was, in our view, at least some obligation on the part of the external managers hiring placement agents to monitor whether the millions of dollars in fees they were paying were, in turn, corrupting internal processes at CalPERS. It seems clear now that

the sheer volume of placement agent fees paid did play a significant role in compromising, to various degrees, the individuals discussed earlier.

Our initial set of recommendations issued in December included a number of observations relating to the fee component of our review. Although we will not repeat them all here, some are highlighted and expanded upon, particularly as they bear on the fitness discussion above.

A. Placement Agent Arrangements

Our review indicated that there were primarily two types of placement agent firms enlisted by external managers seeking investments from CalPERS. In the main, the first type of placement agent firm was small, often "local" (based in or near California), and had close connections with CalPERS Board members or staff. This type of firm was hired primarily because of its contacts, and was paid specifically or principally for CalPERS investments. Of the approximately \$180 million that appears to have been paid to placement agent firms by external managers in connection with CalPERS investments, over \$120 million was paid to placement agent firms of this type, including ARVCO, Tullig (Donal Murphy), DAV/Wetherly Financial, and three firms affiliated with Darius Anderson (Platinum Advisors, Gold Bridge Capital, and Gold Coast Capital).

Sometimes, as in the case of Buenrostro and Shimada with Villalobos, or Michael McCook (a former real estate SIO at CalPERS) with Darius Anderson, to name a few examples, this first type of firm employed former CalPERS officials. Perhaps not surprisingly, these firms sometimes competed with each other. At one point, Daniel Weinstein, head of the DAV/Wetherly Financial firm, jabbed Shahinian after leaving him a number of messages without a reply, saying "Don't know, maybe I should change my

last name to Villalobos to insure that I get a call back." One external manager, Ares Management LLC, took the unusual step many years ago of using ARVCO, DAV/Wetherly Financial, and Platinum Advisors, apparently in an attempt to avail itself of connections by each.

The second type of placement agent firm tended to be hired because of its broader relationships with institutional investors across the country. These more national firms often were affiliated with large financial institutions. This type of firm typically placed no more than 15 percent of a total fund with CalPERS. Unlike the first type of placement agent firm that was hired specifically for its contacts with CalPERS, these firms generally could move on to the next institutional investor on a long list and still obtain fees even if an investment could not be placed with CalPERS. Although we found no situations in which investment staff felt pressured in connection with funds associated solely with these types of placement agent firms, some of these firms still made millions of dollars by placing a large number of investments across a broad range of external managers.

Regardless of the type of placement agent firm used by an external manager, and even in the absence of pressure being brought to bear on the investment staff, we remain concerned, as we said in December, that CalPERS as a limited partner initially paid for placement agent fees in many of these cases, notwithstanding later offsets against the management fees paid to external managers. As we also said in December, and while there is disagreement, many believe that this practice raised the cost of these funds and, in turn, reduced investment returns.

It is our expectation that, in addition to other steps implemented by CalPERS, recently enacted California Assembly Bill No. 1743 ("AB 1743"), which bans placement

agents from receiving fees contingent on their placing investments with state retirement systems like CalPERS, will significantly reduce placement agent fees paid by external managers in the future. Asset management firms are not likely to pay large, non-contingent placement agent fees. For example, it is highly unlikely that a newer (at that time) external manager like Relational Investors LLC would have agreed to pay Donal Murphy and his firm, Tullig, \$17 million in placement agent fees if those fees had to be paid regardless of whether CalPERS ultimately made an investment. In fact, it is hard to believe any external manager, new or established, would have accepted that level of expense as sunk cost. (Instead, Relational agreed to an arrangement with Murphy and Tullig more than a decade ago that continued to pay them as CalPERS invested further with Relational, even though Murphy and Tullig apparently did little or no additional work to secure those follow-on commitments. Given Relational's investment success over the years, the amount paid to Murphy and Tullig grew to \$17 million.)

Moreover, the contingent payment ban under AB 1743 could significantly reduce the future involvement of the second, more national type of placement agent firm if a different compensation structure has to be used for CalPERS and other California pension fund investments (*i.e.*, a flat fee or no fee) in possible contrast to those of other institutional investors across the country. The need to register as a lobbyist in California may also have a discouraging effect on the involvement of this type of firm in future CalPERS investments.

Apart from the conduct of the CalPERS Board members and staff discussed earlier, one of the most troubling discoveries we made was that placement agent fees were being paid for new investments even though the external managers had strong

existing relationships with CalPERS and, at times, even though there were apparently no additional services provided by the placement agent. Looking back, a number of CalPERS external managers paid placement agent fees despite those conditions, in a manner perhaps akin to Medco continuing to pay Villalobos a \$20,000 monthly fee as noted earlier. While there is ample room for disagreement, these payments could be said to have operated more as a form of "insurance" against making an enemy (and the placement agent then using its connections against the firm) and the firm risking the loss of investments or contracts that CalPERS likely would have entered into anyway.

Close attention should be paid in the future to any "repeat" or trailing fees as they could, in some instances, be used to circumvent the contingent payment ban under AB 1743. For instance, in lieu of a contingent fee arrangement, a placement agent might perceive its contacts to be so strong that it would perhaps instead demand a substantial "consulting" fee to monitor the CalPERS relationship and ensure that nothing went wrong. Granted, that alternative compensation arrangement would likely not have been as lucrative as a contingent fee, but it highlights the need for ongoing diligence even after the enactment of AB 1743.

B. Investment Office Staff and Investment Consultants

As we also said in December, not all of the blame for using placement agents rests with external managers. There was a perception among a number of investment managers that the CalPERS investment office was not accessible without such assistance. The apparent conduct of Buenrostro, for example, and his apparently close connections with Villalobos and other "friends of Fred" did not help. The investment office now

understands the problems that this perception created and its current Chief Investment Officer has taken substantial steps to improve access for potential new external managers.

It is critical that the CIO and the investment office continue pursuing these safeguards, as one of the harms that may have resulted from the use of placement agents was that well-qualified managers were perhaps crowded out in favor of those with better connections. Because private equity, for example, only constitutes a portion of the CalPERS investment portfolio, there was not an unlimited amount of capital to invest and not every qualified investment could be made by CalPERS. It is possible that, in some cases, proposals backed by placement agents may have been reviewed and selected ahead of other equally-qualified investments, or that some equally-qualified investments could have received less funding than they otherwise might have. Although there may not have been direct losses from these types of "foregone" investments, CalPERS certainly was harmed if capable money managers believed that the process was not fair and if they did not continue to bring qualified investments to the attention of its investment staff. No one can now doubt the need for investment staff to ensure that each suitable proposal is duly considered.

With regard to the possibility of inappropriate investment fund selections being made due to placement agent involvement, however, we found that the internal investment staff did withstand the apparently related pressure exerted by Buenrostro and others. But for that resolve, things would have been much worse. In addition to paying management and other fees that were at times too high, CalPERS could have entered into a variety of improper investments as a result of placement agent activities that caused substantial losses to the pension fund. That was apparently not the case.

In addition to its internal investment staff, CalPERS also employs outside investment consultants. Those consultants are expected to provide independent and objective advice to CalPERS for a fee. Some of those consultants also have been allowed to act as external investment managers for CalPERS. It is difficult to see how an external manager could objectively advise CalPERS on appropriate levels of management and other fees for its peers and competitors when that advice could raise questions about the level of its own asset management fees. As our discussion above suggests, allowing these investment consultants to play multiple roles of this kind has not always served CalPERS well. We raised these issues in our recommendations last December, and do so again now, as we cannot overstate the importance of the role played by investment consultants in safeguarding the integrity of the CalPERS investment process.

V. Remedial and Related Efforts

In addition to determining whether the interests of the institution's participants and beneficiaries were harmed by the use of placement agents or related activities, our mandate included pursuing remedial measures addressing any such harm and making recommendations to prevent future harm. We discuss these and related efforts below.

A. Actions Relating to Personnel and Fees

The first concern for a pension or trust fund in any case like this is to ensure that those fiduciaries who engaged in misconduct are no longer able to deal with the assets of the fund. Whether by retirement, resignation or termination, that step was accomplished before or during the last 18 months with regard to those whose conduct is illustrated above. Based on the information available to us relating to these issues, we do not believe that further departures will be necessary.

In addition to mitigating the potential for future harm, a pension fund should be made whole with respect to prior harm. CalPERS continues to evaluate its remedies with regard to the harm caused by the use of placement agents and related activities. For example, we note that when a fiduciary is enriched in connection with a breach of its, his or her duties, such enrichment is owed back to the fund the fiduciary had a duty to serve. This remedy exists regardless of any other loss (or even gain) that may have resulted from the actions involving the fiduciary. We continue to advise CalPERS separately on these matters.

Our review of placement agent arrangements and activities did not reveal a case centered on imprudent investment selections by fiduciaries that resulted in substantial losses in principal. Rather, apart from any inappropriate gain on the part of former fiduciaries, it appears more simply that CalPERS' returns were reduced because the investment management and other fees charged were higher than they should have been. Those high fees, in turn, allowed for placement agent fees that were apparently used to compromise certain individuals to the detriment of CalPERS. These issues might have been addressed at the time had there been full disclosure of the placement agent fees being paid.

CalPERS continues to review its relationships with external managers that may have used placement agents. As the largest state pension fund in the country, CalPERS has contracts or other arrangements with hundreds of external investment managers and contractors. CalPERS and the special review have already worked with several external managers in various asset classes to realign their relationships with the institution in a precedent-setting fashion. Recognizing the difficulties that arose from their use of

placement agents, and consistent with their leadership in the financial industry, these firms – Apollo, Relational, Ares and CIM – agreed to a total of \$215 million in fee reductions for CalPERS. They also agreed to no longer use placement agents for new CalPERS investments as well as additional safeguards and other measures aimed at making their relationships with CalPERS stronger. There are other firms, however, for whom CalPERS has decided that no agreement could provide the necessary safeguards, and CalPERS has decided to either terminate those relationships or not enter future relationships with those firms. There is also a third group of firms that have outstanding issues relating to placement agents (albeit for smaller amounts) that have not yet been addressed but merit further pursuit by the institution, as we recommended in December.

We commend the current leadership of CalPERS for its sustained efforts in helping obtain these fee reductions and in beginning the process of realigning the interests of CalPERS and its external managers. After helping secure the over \$200 million in fee reductions discussed above, CalPERS has gone on to obtain another \$100 million from a number of other external managers and has started a broader conversation in the private equity industry regarding fees, consistent with CalPERS' leadership role among public pension funds.

B. Additional Recommendations

Economic issues aside, the reputational harm to CalPERS caused by the use of placement agents and related activities can only be repaired through a sustained commitment to policies that minimize the risk of recurrences of conduct of the kind discussed above. The CalPERS Board and staff have acted on the vast majority of the

recommendations we made in December 2010. This report should provide further support for the need to implement those recommendations.

In that regard, we point back to the conduct of the former officials discussed above and emphasize again the corrosive effect on CalPERS' reputation of the gift issues it has faced in connection with placement agents and more broadly. In principle, when a fiduciary to a pension fund accepts a gift that is provided by a third party because of the fiduciary's connection to the pension fund, that gift rightly belongs to the pension fund. Whether a free dinner, an expensive bottle of wine or a trip overseas, the acceptance of these types of gifts raises issues that vary only by degree. These are serious issues, and CalPERS should take the lead in making sure that no one can ever claim in the future that a decision at CalPERS was swayed by the receipt of a gift, no matter how small. Moreover, when a third party sends an unsolicited gift to a CalPERS Board or staff member, the cost of reporting and disposing of that gift can be burdensome. That is why we suggested also penalizing the gift givers as a way to minimize the number of these incidents over time. That might be combined with an educational effort directed toward third parties that deal with CalPERS. Regardless of the ultimate approach, the end result should be an understanding on the part of third parties that if they provide gifts to CalPERS Board members or staff, they risk tainting the reputations of those public servants and the institution and, as a result, the institution will take steps to make sure that those third parties are left worse off with respect to the institution (whether by sanctions or discontinuation of business relationships) than if they had provided no gifts at all.

In addition to the recommendations we previously issued, we add here another four that we consider equally important. These recommendations relate specifically to the CalPERS Board and its procedures and policies.

First, ethics-related proposals made in good faith to a Committee of the CalPERS Board should not be allowed to languish in that Committee. It is very possible that if, in 2007, the CalPERS Benefits and Program Administration Committee had acted on the placement agent disclosure recommendations made by the staff, the matters giving rise to the special review may have been minimized. Unfortunately, we will never know. We recommend that the Board adopt a policy providing that any ethics-related proposal (as designated by the President of the Board, the Chair of a Board Committee, or jointly by the Chief Risk Officer and General Counsel) introduced to any Board Committee be brought to a vote in that Committee no later than the third regular Committee session after it is introduced (or six months, if earlier). If not brought to a vote by that time, the ethics-related proposal would have to come before the full Board at its next meeting.

Second, given the incidents relating to certain off-site meetings of groups of Board members to discuss CalPERS-related business, additional training should be provided to Board members with regard to the requirements of California's Bagley-Keene Open Meeting Act. CalPERS-related business should be decided at publicly-noticed meetings, not by sub-groups of the Board at other locations. The Board should adopt additional policies in this regard that are consistent not only with the Bagley-Keene Act, but with each Board member's duty to bring independent and informed judgment to CalPERS' decision-making processes and with Section 20153 of the California Government Code (relating to restrictions on communications with applicants or

bidders). No vendor or external manager should ever be led to believe that an off-site meeting at the home of a placement agent (or of anyone else for that matter) is a sanctioned meeting of the CalPERS Board. Tours provided by vendors (or potential vendors) for selected Board members should be closely monitored and disclosed to the full Board as well. Each Board member (or Board Committee member, as the case may be) should have access to the same information as the others in making investment or contracting decisions, and each Board member should be apprised of any external influences (from placement agents or others) being brought to bear on that process. Consideration should also be given to the merits of CalPERS calling for legislation expanding the scope of Section 20153 of the California Government Code if the current statutory language is viewed as being too narrow in terms of its prohibitions to permit the Board to take comprehensive protective action on these issues.

Third, the Board should develop policies and procedures to better address the risks associated with Board members who are experiencing serious financial difficulties. For example, CalPERS should never again be placed in the position of making large travel expense or other monetary advances to a financially-troubled Board member. In the case of Valdes, these advances appear to have been used by him as effectively interest-free loans from CalPERS, rather than for sanctioned business travel as intended. More broadly, Valdes' apparent desire for free dinners and similar gifts from third parties was known to many outside of CalPERS and harmed the reputation of the institution and of the Board, particularly when he was the Chair of its Investment Committee. That, in turn, seemed to contribute to the view by some external managers that they needed to offer gifts and to deal with placement agents close to certain Board members.

The Board should also consider the other risks posed by a Board member with ongoing financial difficulties, including whether elevating such a member to the Chair of its Investment Committee (or any Committee) is in the best interests of the institution or even of the Board member. Those issues should be reviewed by the Risk Management (or similar) Committee of the Board in order to determine, consistent with applicable federal and state law, the policies and procedures that may be implemented to prevent these types of problems in the future. The Board and its President must be empowered by policies on these points ahead of time, instead of being left to make difficult decisions on an *ad hoc* or *post hoc* basis.

Finally, the Board must do more to minimize the risk of inappropriate sharing of sensitive CalPERS information with individuals outside the institution who might benefit from that information. For example, never again should there be questions about whether internal CalPERS information was inappropriately shared during an RFP process. There is no better way to discourage qualified bidders from participating in these RFP processes in the future than to allow for such conduct. Rather, consistent with its fiduciary obligations to participants and beneficiaries, the Board should do everything it can to encourage and enforce a fair process and broad participation by a variety of qualified vendors. CalPERS has already taken the first step by implementing our recommendation regarding the disclosure by applicant vendors of the use of any third-party agent or consultant in connection with an RFP. Further steps should include individualized coding and watermarking of sensitive internal documents, so that inappropriately released materials may be traced back to their source, as well as increased Board member training on the protection and handling of confidential information.

VI. Conclusion

Almost two million people – employees, retirees, spouses, children and other beneficiaries – rely on CalPERS in one way or another for retirement income or health benefit security. Many of them are rightfully disappointed and, like us, will find the apparent conduct of certain of their former public officials disgraceful. The controversy relating to placement agents and related activities exposed structural weaknesses in CalPERS' existing controls. Although the failures of individuals were what damaged CalPERS and gave rise to the need for the special review, the best policies and procedures should always anticipate that individuals may fail to live up to their ethical and fiduciary obligations. With over \$225 billion in assets to manage and over 2,300 employees (not to mention thousands of others who work for outside contractors and investment partners), there is no way to ensure that every individual associated with the institution will always act properly. Over the last year, CalPERS has taken significant steps to address the fitness, fee and other issues raised by the special review. The institution also continues to assess other remedies it may have and remains committed to assisting law enforcement authorities that continue to pursue their own investigations and actions against those who may have harmed the interests of the pension fund.

Armed with recent legislative and policy changes, CalPERS should continue to be diligent in monitoring placement agent and similar relationships. We cautioned in this report about the ways in which the next generation of placement agents might operate in connection with investment and other business. Although it is unlikely that the events of the last ten to fifteen years could repeat themselves to the same extent, there must be increased vigilance on the part of CalPERS as to those portions of its investment portfolio

– like private equity, real estate and hedge funds – that have not traditionally been subject to as great a degree of public scrutiny as other types of investments. We also made clear that CalPERS' investment portfolio is not the only area that may be susceptible to inappropriate influences, and trust that RFP processes and procedures will continue to be reviewed and improved further over time.

The most important thing to participants and beneficiaries is that the financial harm caused by placement agent activities has been (and continues to be) mitigated, and that future harm is prevented. CalPERS should continue its successful efforts in this regard, including improved access for external manager investment proposals so that no firm feels that it must hire a placement agent in order to succeed in Sacramento. Further, the investment office staff should continue its efforts in realigning the interests of external money managers with those of the institution, including ensuring that management and incidental fees (as distinct from incentive fees) are not profit centers for its external managers.

Finally, we hope that this report also serves as a reminder to every CalPERS staff and Board member – like those across the country charged with the duty of overseeing the retirement and benefit security of government workers – that theirs is a sacred trust, and one that should never be compromised for personal gain or outside interests.

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CalPERS Special Review: Selected Recommendations

I. Overview

Over the last year, CalPERS and its special review, led by Steptoe & Johnson LLP, have been actively investigating and addressing issues raised by the use of placement agents to determine whether the interests of participants and beneficiaries were compromised by the payment of placement agent fees and related activities. That work has been guided, in good part, by Article XVI, Section 17 of the California Constitution, as well as Section 20151 of the California Government Code, which provide that the CalPERS Board of Administration, its executive officers and other employees are to discharge their duties solely in the interest of CalPERS participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries, defraying reasonable expenses of administering the system, and investing with the care, skill and diligence of a prudent person.

In the context of the special review, we have summarized these requirements into two categories: fitness and fees. With regard to fitness, our inquiry has focused primarily on whether CalPERS Board members, officers and employees have lived up to the high standards imposed upon them. We have also been considering qualitative fitness issues regarding the external money managers that serve CalPERS and support its investment process and objectives. With regard to fees, our inquiry has focused primarily on whether, during its investment process, CalPERS was misled or made to overpay, resulting in increased expenses and, ultimately, harm to the system's participants and beneficiaries.

As we approach the final stages of our review, we offer the following organizational and operational recommendations as they relate to placement agents and associated activities. These recommendations are intended to address issues we have observed with regard to fitness, fees and related requirements. Over the last year, CalPERS has taken significant steps in implementing many of these recommendations. To that extent, our comments here are intended to provide a framework to support those good actions. Our expectation is that the remaining recommendations will also be embraced by CalPERS Board members and management as the institution strives to implement a more modern governance model and set a standard for other public pension funds to follow.

II. Selected Recommendations

A. Recommendations Relating to Fitness Component of Special Review

Issues relating to the fitness of certain former CalPERS Board members, officers and employees have been reported widely in the press over the last year and will be discussed when the special review is completed. In the interim, selected related issues affecting the organization and operation of CalPERS are outlined below, along with observations and recommendations.

All of these recommendations share the common goal of maintaining an environment in which the many talented and dedicated employees of CalPERS may proudly perform their duties on behalf of members and beneficiaries without the ongoing cloud of ethical lapses caused by a relative few former Board members, executives and employees.

1. Institutional Risk Management and Oversight

Observation: The controversy involving placement agents and related activities has posed significant financial and reputational risks to CalPERS as an institution. Historically, no one at CalPERS has had exclusive responsibility for managing institutional risk or handling ethics concerns expressed by staff and Board members. Instead, that responsibility was spread across different offices and officers including the Chief Investment Officer, the Chief Compliance Officer, the Chief Executive Officer, and the General Counsel and Legal Office. Corporations and other institutions have come to recognize the importance of comprehensive risk management at the executive level. There is also a growing recognition of the benefits of a centralized office, with a single responsible executive, to address risk on an institution-wide basis. In the best cases, those officers are also overtly designated to address ethics concerns expressed by employees and have responsibility, and the resources and other support, to address them.

Institutions have also come to appreciate the merits of assigning to a single committee of their Boards of Directors or Trustees the responsibility for oversight of the institution's risk management function. Historically, however, no single committee of the CalPERS Board of Administration has been vested with this responsibility.

Recommendation: CalPERS and its leadership have been carefully considering the best operational structure to give sufficient attention to risk management, including ethics oversight. CalPERS recently created the position of Chief Risk Officer with overarching responsibility for risk management across all of its offices. That officer is also intended to serve as the lead point of contact for employees with ethics concerns, and a hotline has been established to facilitate reporting. Given the importance of the Chief Risk Officer's work, and to alleviate the need for reporting relationships to every committee of the board, we also recommend that the CalPERS Board assume formal oversight responsibility for the risk management function of the organization either by creating a separate and standing risk management committee, or by assigning the regular review of risk management matters to the oversight portfolio of an existing committee of the Board.

2. Gifts and Travel

Observation: During the course of our investigation, we learned that external money managers and others, including placement agents, paid for expensive meals and provided substantial gifts to CalPERS staff and Board members. Some of these meals and gifts were not reported on the required forms. We also learned that, until 2008, external managers made and paid for extraordinary travel arrangements, including air travel by private jet, for various CalPERS staff and Board members. This travel was not reported on the required gift forms, in some cases because it was provided pursuant to clauses in agreements between CalPERS and its investment

managers which specified that their investment partnerships were to pay for those trips. Gifts, meals and travel of this kind may create potential fitness issues and conflicts of interest, or at least the appearance of them, and suggest that decisions could be made for reasons other than the merits of a particular investment. No gift, meal or trip is worth compromising the integrity of the CalPERS investment process, or creating an appearance that it has been compromised.

Recommendation: We recognize that CalPERS now requires investment staff members to adhere to stringent new policies when traveling for meetings with investment managers. We also support the ban on gifts adopted by CalPERS regarding its staff, and recommend that this step be reinforced by enhanced training and certifications and that similar policies be adopted to apply to its Board members. Failure to comply with CalPERS gift and travel policies should have disciplinary consequences not only for staff or Board members, but also for the external manager or other firm in question. Going forward, either contractually or by regulation or legislation, any firm involved in two or more violations of these gift and travel policies should be prohibited from doing business with CalPERS for a period of not less than two years.

3. Certain Post-CalPERS Employment of Board Members and Staff

Observation: As the largest pension fund in the country, CalPERS has contracts or other arrangements with hundreds of external investment managers and contractors. California law currently permits former CalPERS Board members and employees to go to work for these external managers or contractors, without delay, so long as they do not immediately represent these firms before CalPERS. Although important, that proscription does not prevent a CalPERS Board member or employee from putting the interests of external managers, other contractors or their agents ahead of CalPERS in the hope of securing subsequent employment or similar consideration that does not require representation before CalPERS. Federal law, by contrast, imposes a “cooling-off period” on federal employees who award or manage contracts in excess of \$10 million, and does not permit immediate employment with the recipients of such contracts.

Recommendation: A company doing significant business with CalPERS (or an agent of such a company) should not be permitted to hire, immediately upon their departure from CalPERS, former Board or staff members who materially participated in decisions relating to that company. To that end, we recommend that CalPERS call for legislation going beyond the minimum requirements of California law and adopt a “cooling-off period” for its former Board and staff members similar to that provided under federal law. Specifically, a CalPERS Board or staff member should be prohibited from working for any company or its agents during a two-year period after termination of Board service or employment if, within the previous five years, CalPERS had an agreement with that company (including an agreement to manage funds on behalf of CalPERS) that exceeded \$10 million in value and that Board or staff member was materially involved in awarding or managing that agreement or investment. Moreover, a Board or staff member should be prohibited from working for any placement agent during the cooling-off period if that placement agent placed an investment with CalPERS during the previous ten years and regardless of whether the Board or staff member was materially involved in the decision to invest.

4. Responsiveness to Public Records Act Requests

Observation: The press has served a critical role in educating CalPERS participants and beneficiaries, as well as the public at large, about issues regarding placement agents and related activities. Prompt and adequate attention to Public Records Act requests plays an important part in ensuring the ongoing fitness of the operation and organization of CalPERS. At times, and often due to the sheer volume of requests (recently, regarding placement agents, for example), the staffing of Public Records Act responses has not been adequate. In addition, staff members occasionally have been put in the position of overseeing requests for documents in matters where they were materially involved.

Recommendation: Recognizing the importance of responding to public record requests and producing those documents that can and should be released, we recommend that additional staff be trained and dedicated to these tasks. It is also important that sufficient staff be dedicated to these tasks so that staff members who bear operational responsibility for the issues that are the subject matter of the underlying request are not also primarily overseeing or writing the final response to the public records request.

5. Internal Audit Program

Observation: The special review has also identified weaknesses that impaired the effectiveness of the CalPERS Office of Audit Services, its internal audit function. In particular, conclusions reached by the audit staff were occasionally overlooked and recommendations were not always implemented, especially with respect to audits of travel expenditures.

Recommendation: The Office of Audit Services and its staff dedicate substantial resources to their investigations. Their efforts should be recognized by implementing a reporting relationship that ensures that recommendations are considered by the highest levels of the institution, and that maintains the independence that the sensitive functions of this office demand. We recommend, therefore, that the Office of Audit Services report regularly to the CalPERS Board. We also recommend that there be greater accountability and timely resolution of findings by managers in response to internal audit findings and recommendations, and regarding travel expense matters in particular. We encourage the new Chief Risk Officer to play an active role in this effort as well.

B. Recommendations Relating to Fees Component of Special Review

External money management fees constitute the largest recurring expense for CalPERS. It was and remains, in the first instance, the responsibility of CalPERS staff and its investment consultants to negotiate and monitor these types of fees. At least in hindsight, the excessive nature of some of these fees created an environment in which external managers were willing and able to pay placement agent fees at a level that bore little or no relationship to the services apparently provided by the placement agents. Further, in some cases, placement agent fees were paid for new investments even though the external managers had existing relationships with CalPERS and, at times, even though there were apparently no additional services provided by the placement agent. In a sense, many of the abuses relating to placement agent arrangements were

merely a symptom of a larger problem relating to the prudence of certain external manager fees paid by CalPERS.

For this reason, the fee component of the special review has focused on whether CalPERS was made to overpay or bear increased costs that reduced investment returns for the pension fund. In the course of addressing these issues, CalPERS, through the special review, obtained over \$200 million in fee concessions from external managers in various asset classes. Following those results, CalPERS investment staff later secured an additional \$100 million in fee reductions from a number of other large external money managers. This should be the beginning, not the end, of efforts to ensure a close alignment of interests between CalPERS and the external money managers that it entrusts with pension plan assets.

Fairly addressing the issues associated with the use of placement agents requires an examination of not only the conduct of external managers but also the perceptions that shaped that conduct. To be clear, not all of the blame for the use of placement agents rests with external managers. There was a perception among a number of investment managers that the CalPERS investment office was not accessible without such assistance. The investment office now plainly understands the problems that this perception created and its Chief Investment Officer has stated publicly that placement agents are not necessary to secure capital commitments from CalPERS. A recent step to improve access for potential new external managers is the implementation of a direct line to the investment office for the submission of proposals, and dedicating staff to ensure that each proposal is duly considered.

The recommendations below address additional systemic issues observed in connection with the fee component of our review. The goal of all of these recommendations is to improve the prudence, integrity and transparency with which the CalPERS investment function operates.

1. Relationships Between External Managers or Contractors and Placement Agents

Observation: Consistent with its leadership position as the largest public pension fund in the United States, CalPERS set the standard for obtaining disclosures from all of its external money managers regarding their use of placement agents. In the spring and summer of 2009, CalPERS implemented a comprehensive program, later augmented by the efforts of the special review, to obtain disclosure of the nature and terms of the relationship between every one of its external managers and any placement agent. In the course of our investigation, we also learned that placement agents or others with similar responsibilities have been used by firms other than external managers to secure contracts from CalPERS.

Recommendation: Over the last year, the CalPERS Board developed and approved placement agent policies that were instrumental in forming the basis for legislative bill AB 1743, which CalPERS strongly supported and was signed into law in California on September 30, 2010. That law regulates placement agents and, in particular, subjects placement agents to the same registration and disclosure regulations that apply to lobbyists. CalPERS should continue to ensure that its policies and the provisions of the new law are fully implemented. Also, because any company doing business with CalPERS could employ a placement agent, we have

recommended, and CalPERS has agreed, that standard language should be included in every Request for Proposal issued by CalPERS requiring the disclosure of any third-party agent or consultant used in connection with the proposal and the terms of that arrangement.

2. Relationships with External Managers that Paid Placement Agents

Observation: CalPERS, through its special review, has worked with several external managers to realign their relationships with the institution in a precedent-setting fashion. Recognizing the difficulties that arose from their use of placement agents, and consistent with their leadership in the financial industry, these elite firms agreed to a total of over \$200 million in fee reductions for CalPERS. They also agreed to no longer use placement agents for new CalPERS investments as well as additional safeguards. There are other firms for whom CalPERS has decided that no agreement could provide the necessary safeguards, and CalPERS has decided to either terminate those relationships or not enter future relationships with those firms. There is a third group of firms, however, that have outstanding issues relating to placement agents (albeit for smaller amounts) that have not yet been addressed but merit further pursuit by the institution.

Recommendation: CalPERS should implement a “placement agent resolution program” to allow those managers that paid placement agents to resolve outstanding issues in a manner consistent with the precedents set by the other agreements recently entered into by CalPERS. Where managers with outstanding placement agent issues decline to cooperate, CalPERS should not consider new investments with those managers. In certain cases, CalPERS may need to end existing business relationships. CalPERS must be able to trust that its managers act in the best interests of its participants and beneficiaries when managing money for CalPERS. Refusing to address outstanding placement agent issues violates that trust and signals a desire to put the interests of the external managers ahead of those of CalPERS. The investment office should regularly report to the Board on the progress being made with external managers on their outstanding issues regarding placement agents.

3. Continued Alignment of Interests of CalPERS and Its External Managers

Observation: CalPERS is an investor of choice for most money managers. Securing an investment from CalPERS often serves as a calling card that managers use to secure investments from other large institutional investors. Nonetheless, over the years, CalPERS often simply accepted what it believed were market terms or conditions, rather than using its size and reputation to secure the best possible terms on fees it pays to have its money managed. We have also noted a proliferation of secondary fees charged atop the core incentive and management fees paid to external money managers. Given the substantial incentive and management fees that these external managers may earn, these other fees appear to be an unnecessary source of profit from CalPERS. The scale of these profits were an apparent excess that helped allow for the payment of placement agents.

Recommendation: CalPERS should sustain its renewed focus on negotiating lower management fees with all of its existing external managers and, from every investment relationship possible, eliminate incidental and other fees including monitoring fees, deal fees and similar transaction fees. To better align the interests of CalPERS with those of its external managers going forward, CalPERS should insist that nearly all of the fees it pays be in the form of incentive fees paid based on the success of its external managers in investing CalPERS assets and not in management or other fees. To assist in this effort, all fees should be documented in a transparent and straightforward manner at the time the investment is first proposed.

4. Payment of Placement Agent Fees from Investment Funds

Observation: Investments made by CalPERS through private equity or real estate firms are typically structured as partnerships in which CalPERS and other investors are limited partners. The firm offering and managing the investment is usually the general partner. It was apparently common for the partnership as a whole, rather than the general partner, to pay the cost of fees for placement agents using funds intended for investment. As a result, and notwithstanding later offsets against management fees paid to the general partner, CalPERS as a limited partner initially paid for placement agents whose role benefited only the general partners and not CalPERS. While there is disagreement, many believe that this practice raised the cost of these funds and reduced investment returns. As important, this practice of offsetting placement agent payments against future management fees also apparently benefited general partners by allowing them to effectively deduct for tax purposes otherwise nondeductible expenses, like placement agent fees. This, in turn, may have increased the amount the general partners were willing to pay to placement agents.

Recommendation: CalPERS should adopt policies that prohibit the direct or indirect payment of placement agent fees from the assets of the partnerships or other funds in which it invests. Such fees should not be paid in connection with a CalPERS investment and, insofar as they may be incurred elsewhere, should be paid directly and exclusively by the general partners managing these funds.

5. Expenses for Annual, Advisory Board and Other Meetings

Observation: Despite the economic downturn, investment fund annual meetings and periodic advisory board and other meetings called by external money managers continue to be held in unduly lavish locations and often involve expensive dinners and entertainment. The expenses associated with these meetings are usually borne by the partnership through funds intended for investment, and increase the costs associated with these funds by decreasing the amount available for investment, ultimately reducing investment returns for CalPERS. While important, the business conducted at these meetings can be done in more modest settings.

Recommendation: Lavish meetings are inconsistent with the mission of CalPERS to prudently invest and manage its trust funds. CalPERS recently acted to limit these excesses by prohibiting its staff from attending entertainment events and meals held apart from business meetings. That is a good first step. Going forward, CalPERS should encourage its external managers to hold all

of these meetings, including annual and advisory board meetings, at the offices of one of the limited partners, including its own in Sacramento, or at the general partner's offices. We recommend that, to facilitate this change, CalPERS should direct its staff to only attend meetings held at those locations. We also recommend that the general partner, and not the partnership, bear the cost of these meetings and that this change be imposed in every current and future investment agreement involving CalPERS.

6. Avoiding Potential Conflicts in Investment Functions

Observation: In addition to its internal investment staff, CalPERS also employs outside investment consultants. These consultants are expected to provide independent and objective advice to CalPERS for a fee. Outside consultants often provide opinions on the prudence of proposed investments, and monitor those and other investments once they are made. Some of these consultants also have been allowed to act as external investment managers for CalPERS. Allowing these investment consultants to play multiple roles of this kind has not always served CalPERS well. In addition, important roles within the CalPERS investment office are shared among staff members wearing multiple hats on the same transaction or with respect to the same investment manager. For example, a staff member in the CalPERS investment office may be responsible for negotiating with external managers and have a mandate to pursue terms that are most favorable to CalPERS. However, that same staff member may also later direct and oversee the relationship with that external manager once the negotiations have concluded. The necessarily adverse positions that the staff person may need to take during negotiations may impair that staff person's ability to foster the cooperative relationship that is later needed to properly manage the investment and ensure that the best returns are achieved.

Recommendation: CalPERS values the roles played by its investment staff and outside consultants, but to ensure objectivity at all stages of the investment cycle, CalPERS should more clearly separate investment functions inside and outside its investment office. Inside the investment office, a chief negotiator or negotiators should be tasked with the responsibility of negotiating all contracts with external managers while other staff assume responsibility for the monitoring and maintenance of those relationships. Further, outside consultants should only be permitted to fulfill one of two functions with respect to a given investment: either providing opinions on the prudence of an investment being considered by CalPERS, or assisting in the monitoring of the investment once made by CalPERS, but not both. Most important, outside investment consultants should never be permitted to also serve as external money managers for CalPERS.

7. Employees Performing Key Investment Functions

Observation: Staff in the CalPERS investment office manage more than \$200 billion of public money and some are among the most highly paid public employees in the State of California due to exceptions from the general civil service pay scales. That compensation is appropriate in light of their responsibilities to manage large sums of money, and the salaries for comparable jobs in the private sector. Notwithstanding their substantially higher compensation compared to other public employees, however, investment office staff are still subject to the general state civil

service rules regarding progressive discipline and termination. In fact, they are paid higher salaries and afforded more civil service rights than even some of CalPERS' most senior executives. While the investment office staff's compensation is higher and can rise further based on investment performance, state civil service rules regarding progressive discipline and termination prevent CalPERS from acting as quickly as might otherwise be appropriate when these staff members fail to discharge their duties as they should.

Recommendation: In the event that highly paid investment office staff do not perform as expected, CalPERS should be able to take disciplinary action more quickly and not have to bear the expense of their high salaries through the normal progressive discipline and termination process generally applicable to civil service employees. To that end, CalPERS should propose to the California legislature and seek the adoption of legislation that substantially streamlines the discipline process for CalPERS investment staff at the portfolio manager level and above, and allows for substantial downward adjustments in their salaries to general civil service pay scales during the discipline and termination process.

* * *

Philip S. Khinda
Donald E. Wellington
Steptoe & Johnson LLP

Ellen S. Zimiles
Navigant Consulting, Inc.

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ATTORNEYS AT LAW

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April 16, 2010

Mr. Leon D. Black
Chief Executive Officer
Apollo Global Management, LLC
9 West 57th Street
New York, NY 10019

CalPERS and Apollo

Dear Mr. Black:

Thank you for your thoughtful proposal, which has become the basis for this new strategic relationship agreement between Apollo Global Management, LLC ("Apollo") and the California Public Employees' Retirement System ("CalPERS"). This letter memorializes the principles and terms that will govern the new strategic relationship, aimed at aligning the interests of the two institutions, with the understanding that you and Joe Dear may revise their implementation as market conditions change and as new investment opportunities present themselves, subject to the formal approval of both Apollo and CalPERS. The requisite approvals for this agreement, once executed, will appear after my signature below.

Apollo has agreed to reduce its management and other fees on funds it manages solely for CalPERS by \$125 million over the course of the next five years, or as close a period as required to provide CalPERS with that benefit, and may include both existing and new investments that Apollo manages solely for CalPERS. Any new investments that CalPERS may make with Apollo will be considered by CalPERS in its sole discretion, based on market terms and appropriate due diligence. As you know, CalPERS has begun its diligence on the new strategic managed account opportunity that Apollo has offered, and it expects to complete that work over the next few months.

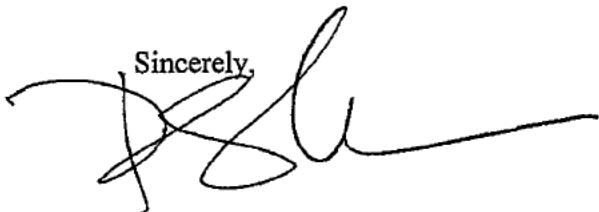
Consistent with new standards and policies issued by CalPERS and the importance of related pending legislation in California, Apollo has also agreed not to use a placement agent in connection with securing any future capital commitment from CalPERS. Apollo has also agreed to provide CalPERS with a certification, each quarter, representing that Apollo has not used or paid any placement agent, directly or indirectly, in connection with securing any new capital commitment from CalPERS.

Mr. Leon D. Black
April 16, 2010
Page 2

Finally, we note our great appreciation for the cooperation that Apollo and its principals have provided to the special review and your commitment to keep doing so. Your efforts were also instrumental in bringing about this new strategic relationship agreement, and set a high standard that we hope others will follow. As the special review remains underway, please be advised that this agreement is without prejudice to the rights of any party to pursue any action that may be deemed appropriate in view of its ultimate findings.

Thank you again for your service to CalPERS over the years and your assistance to the special review.

Sincerely,



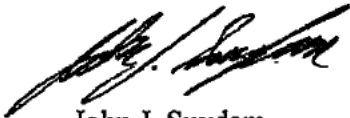
Philip S. Khinda

Acknowledged and Accepted:

Apollo Global Management, LLC
By:



Leon D. Black
Chief Executive Officer

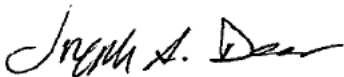


John J. Suydam
Chief Legal Officer

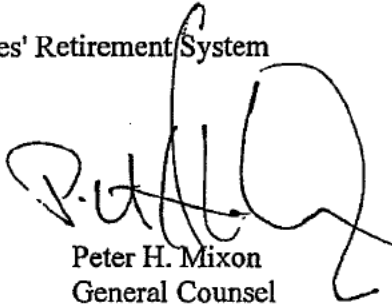


Brad S. Karp
Chair, Paul Weiss
Counsel to Apollo

The California Public Employees' Retirement System
By:



Joseph A. Dear
Chief Investment Officer



Peter H. Mixon
General Counsel

STEPTOE & JOHNSON LLP
ATTORNEYS AT LAW

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June 9, 2010

Mr. Antony P. Ressler
Managing Partner
Ares Management LLC
2000 Avenue of the Stars
Los Angeles, CA 90067

CalPERS and Ares

Dear Mr. Ressler:

During our discussions regarding the special review that we have been conducting for CalPERS, the California Public Employees' Retirement System, you made a proposal that CalPERS greatly appreciates and that has formed the basis for this new strategic relationship agreement between CalPERS and Ares Management LLC ("Ares"). This letter memorializes the principles and terms that will govern the new strategic relationship, aimed at aligning the interests of the two institutions, with the understanding that you and Joe Dear may revise their implementation as market conditions change and as new investment opportunities present themselves, subject to the formal approval of both Ares and CalPERS. The requisite approvals for this agreement, once executed, will appear after my signature below.

Ares has agreed to reduce its management and other fees on funds it manages solely for CalPERS by \$10 million over the course of the next five years, or as close a period as required to provide CalPERS with that benefit, and may include both existing and new investments that Ares manages solely for CalPERS. Any new investments that CalPERS may make with Ares will be considered by CalPERS in its sole discretion, based on market terms and appropriate due diligence. I know that Joe Dear looks forward to exploring these opportunities with you and your team in the months ahead.

Consistent with new standards and policies issued by CalPERS and the importance of related pending legislation in California, Ares has also agreed not to use a placement agent in connection with securing any future capital commitment from CalPERS. Ares has also agreed to provide CalPERS with a certification, each quarter, representing that Ares has not used or paid any placement agent, directly or indirectly, in connection with securing any new capital commitment from CalPERS.

June 9, 2010
Page 2

Finally, we note our great appreciation for the cooperation that Ares and its principals have provided to the special review and your commitment to keep doing so. Your efforts from the outset have been exemplary, and instrumental in bringing about this strategic relationship agreement. As the special review remains underway, please be advised that this agreement is without prejudice to the rights of any party to pursue any action that may be deemed appropriate in view of its ultimate findings.

Thank you again for your service to CalPERS over the years and your assistance to the special review.

Sincerely,

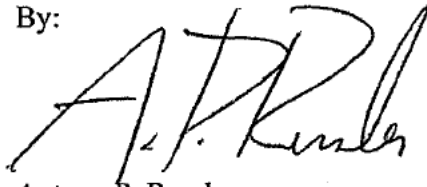


Philip S. Khinda

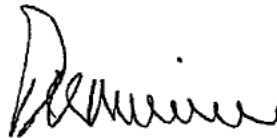
Acknowledged and Accepted:

Ares Management LLC

By:



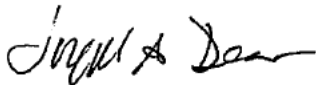
Antony P. Ressler
Managing Partner



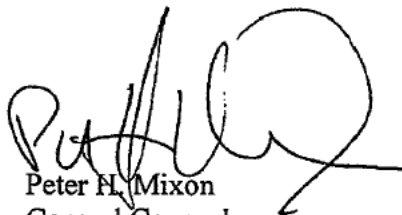
Michael D. Weiner
General Counsel

The California Public Employees' Retirement System

By:



Joseph A. Dear
Chief Investment Officer



Peter H. Mixon
General Counsel

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ATTORNEYS AT LAW

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June 11, 2010

Mr. Ralph V. Whitworth
Principal and Founder
Relational Investors LLC
12400 High Bluff Drive, Suite 600
San Diego, CA 92130

CalPERS and Relational

Dear Mr. Whitworth:

Many thanks to you and your colleagues at Relational Investors LLC (“Relational”) for your work over the years on behalf of CalPERS, the California Public Employees’ Retirement System. As Joe Dear and others hope you know, CalPERS greatly appreciates the importance and impact of the corporate governance initiatives that you and Relational have pursued through your investment endeavors, and your affirmation and support of CalPERS’ related priorities. During our discussions regarding the special review that we have been conducting for CalPERS, when we discussed our comfort with our current findings as well as our comfort with Relational and its principals, you made a proposal that CalPERS appreciates and that has formed the basis for this new strategic relationship agreement between CalPERS and Relational. A key component of the new strategic relationship will be the creation of a state of the art fee structure that we all hope will become a model for your asset class. This letter memorializes the principles and terms that will govern the new strategic relationship, aimed at aligning the interests of the two institutions, with the understanding that you and Joe Dear may revise their implementation as market conditions change and as new investment opportunities present themselves, subject to the formal approval of both Relational and CalPERS. The requisite approvals for this agreement, once executed, will appear after my signature below.

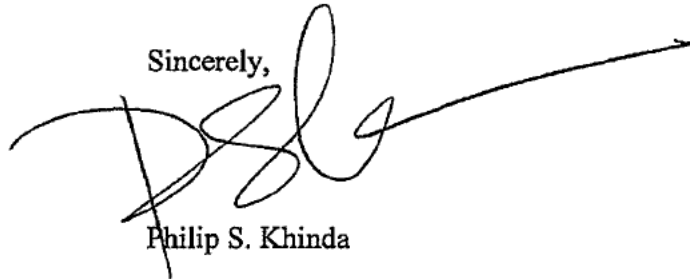
In going forward together, Relational has agreed to reduce its management and other fees on funds it manages for CalPERS by \$30 million over the course of the next five years, or as close a period as required to provide CalPERS with that benefit, and may include both existing and new investments that Relational manages for CalPERS. Any new investments that CalPERS may make with Relational will be considered by CalPERS in its sole discretion, based on market terms and appropriate due diligence. I know that Joe Dear looks forward to exploring these opportunities with you and your team in the months ahead.

Consistent with new standards and policies issued by CalPERS and the importance of related pending legislation in California, Relational has also agreed not to use a placement agent in connection with securing any future capital commitment from CalPERS. Relational has also agreed to provide CalPERS with a certification, each quarter, representing that Relational has not used or paid any placement agent, directly or indirectly, in connection with securing any new capital commitment from CalPERS.

Finally, we note our great appreciation for the cooperation that Relational and its principals have provided to the special review and your commitment to keep doing so. Your efforts from the outset have been exemplary, and instrumental in bringing about this strategic relationship agreement. As the special review remains underway, please be advised that this agreement is without prejudice to the rights of any party to pursue any action that may be deemed appropriate in view of its ultimate findings.

Thank you again for your service to CalPERS over the years and your assistance to the special review.

Sincerely,

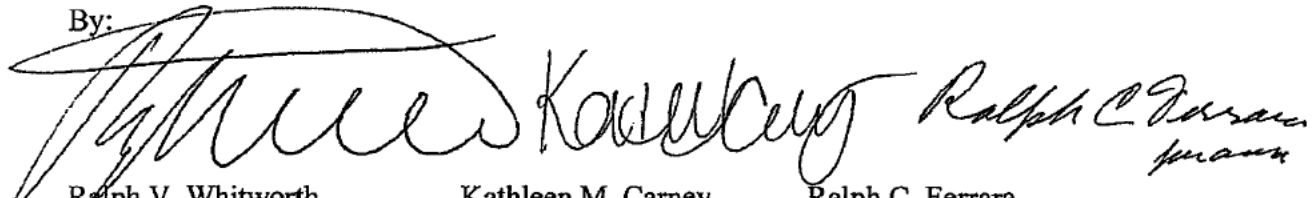


Philip S. Khinda

Acknowledged and Accepted:

Relational Investors LLC

By:



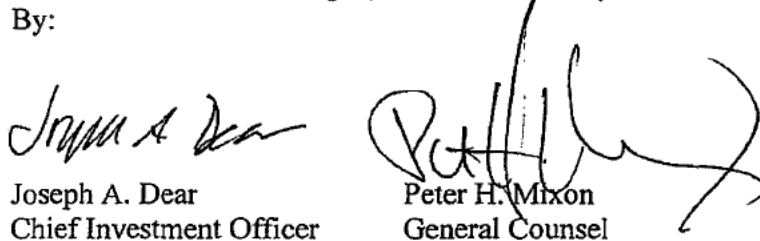
Ralph V. Whitworth
Principal and Founder

Kathleen M. Carney
Senior Legal Counsel

Ralph C. Ferrara
Vice Chair, Dewey & LeBoeuf
Counsel to Relational

The California Public Employees' Retirement System

By:



Joseph A. Dear
Chief Investment Officer

Peter H. Mixon
General Counsel

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October 17, 2010

Mr. Avraham Shemesh
Mr. Richard S. Ressler
CIM Group LLC
6922 Hollywood Boulevard
Los Angeles, CA 90028

CalPERS and CIM

Gentlemen:

Many thanks to you and your colleagues at CIM Group LLC (“CIM”) for your strong efforts and contributions on behalf of CalPERS, the California Public Employees' Retirement System. As Joe Dear and others hope you know, CalPERS greatly appreciates the urban investment discipline that CIM has applied over the years to CalPERS' investments, and its resulting performance to date for CalPERS and its beneficiaries. During our discussions regarding the special review that we have been conducting for CalPERS, you made a proposal that CalPERS appreciates and that has formed the basis for this new strategic relationship agreement between CalPERS and CIM. This letter memorializes the principles and terms that will govern the new strategic relationship, aimed at aligning the interests of the two institutions, with the understanding that you and Joe Dear may revise their implementation as market conditions change and as new investment opportunities present themselves, subject to the formal approval of both CIM and CalPERS. The requisite approvals for this agreement, once executed, will appear after my signature below.

CIM has agreed to reduce its management and other fees on funds it manages solely for CalPERS by \$50 million over the course of the next five years, or as close a period thereafter as required to provide CalPERS with that benefit, and may include both existing and new investments that CIM manages solely for CalPERS. Any new investments that CalPERS may make with CIM will be considered by CalPERS in its sole discretion, based on market terms and appropriate due diligence. I know that Joe Dear looks forward to exploring these opportunities with you and your team in the months ahead.

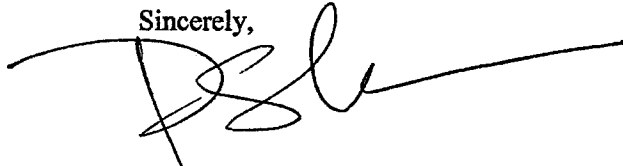
CIM Group LLC
October 17, 2010
Page 2

Consistent with new standards and policies issued by CalPERS and the importance of related new legislation in California, CIM has also agreed not to use a placement agent in connection with securing any future capital commitment from CalPERS. CIM has also agreed to provide CalPERS with a certification, each quarter, representing that CIM has not used or paid any placement agent, directly or indirectly, in connection with securing any new capital commitment from CalPERS.

Finally, we note our appreciation for the cooperation that CIM and its principals have provided to the special review and your commitment to keep doing so. Those efforts were also instrumental in bringing about this strategic relationship agreement. As the special review remains underway, please be advised that this agreement is without prejudice to the rights of any party to pursue any action that may be deemed appropriate in view of its ultimate findings.

Thank you again for your service to CalPERS over the years and your assistance to the special review.

Sincerely,

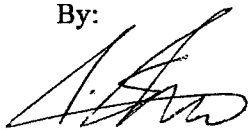


Philip S. Khinda

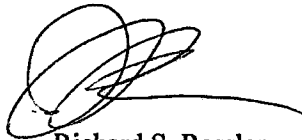
Acknowledged and Accepted:

CIM Group LLC

By:



Avraham Shemesh
Principal and Founder



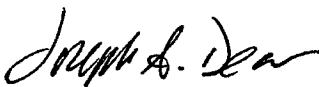
Richard S. Ressler
Principal and Founder



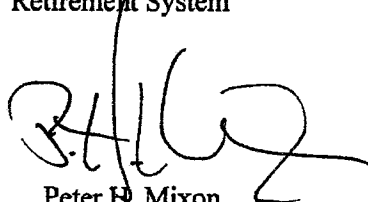
Brad S. Karp, Esq.
Chair, Paul Weiss
Counsel to CIM

The California Public Employees' Retirement System

By:



Joseph A. Dear
Chief Investment Officer



Peter H. Mixon
General Counsel