

Office of
LEGISLATIVE AUDITOR GENERAL
State of Utah

REPORT NUMBER 2003-01
February 2003

**A Review of Possible Staff Conflicts of Interest
at the Utah Retirement Systems**

The Utah State Retirement Board should strengthen the restrictions placed on the personal investment activities of the investment staff. The Chief Investment Officer (CIO) may have made personal investment decisions based on privileged information obtained from his position at the Utah Retirement Systems (URS). We think some of his investments may be inconsistent with the URS conflict of interest policies. In addition, experts advised us that some of the CIO's personal trades may be considered a form of trading on insider or privileged information that is prohibited by state and federal securities laws.

A review of the personal investment activities of the CIO was initiated during a broader audit of the Utah Retirement Systems. While examining documents prepared by URS internal auditors, we discovered information suggesting that the CIO made personal investments that may involve a conflict of interest or possibly a form of insider trading. This discovery led the audit team to ask the Utah Division of Securities for their assistance in our review of the CIO's personal investment activities. Because of the potentially illegal personal investments made by the CIO at the Utah Retirement Systems, we are submitting this letter separately. Our audit of the investment practices at the URS will be reported at a later date.

**The Chief
Investment Officer
may have made
personal investment
decisions based on
privileged
information.**



The CIO's possible use of privileged information is a concern because of his role in the selection and retention of the systems' fund managers. About half of the systems' equity investments are managed by outside consultants who are hired as fund managers due to their expertise in investing in specific market sectors. The remaining half is placed in passive index funds that are designed to mirror the performance of the overall market. It is the responsibility of the CIO to direct and control the recruitment and selection of the systems' fund managers and to monitor their performance. In view of his position of fiduciary trust, it is important that the CIO avoid using information he may receive from fund managers to benefit himself personally. If the CIO were to act on information he received from a fund manager to benefit himself personally, it could compromise his ability to be objective in directing that fund manager.

CIO's Personal Investments Raise Concerns

URS conflict of interest policies prohibit fiduciaries from taking any official action that is "influenced by consideration of personal gain or benefit rather than motivated by the interest of the Systems and their members... ." Furthermore, the policies direct fiduciaries to "studiously and conscientiously avoid ... any reasonable appearance of a conflict of interest." Because the CIO has a key role in the selection and continuing employment of fund managers, apparent conflicts of interest can easily arise. For example, care must be taken to avoid any hint that a fund manager could provide investment tips in exchange for lax monitoring or additional investment fees.

Given the high standard of conduct required from the CIO, we found he engaged in three investment activities that raise serious concerns. The CIO:

- Made a personal investment that may have been designed to benefit from a URS transaction.
- Invested in some of the same small companies in which URS fund managers purchased stock.
- Discussed his own personal investment in a small company with a URS fund manager who purchased shares in the company for URS.

Fiduciaries must avoid any reasonable appearance of a conflict of interest.

The following describes each of the above concerns in detail.

A Personal Investment May Have Been Designed To Benefit From A URS Transaction

The CIO made a personal investment that may have been designed to benefit from a sale of a large block of stock that he made for the URS. In November of 2001, the URS received a distribution of 245,000 shares of stock in Charles River Laboratories International, Inc. On the same day that the CIO ordered the sale of 195,000 of the URS shares, the CIO also bought put options for Charles River Labs stock on his own account. A put option gives a person the right to sell a certain security at a specified price up to a specified date. Similar to stocks, there is a market where an options contract can be bought and sold anytime before its expiration date. Options are leveraged instruments and their prices may fluctuate considerably based on the market's estimate of the underlying stock's future value. Figure 1 identifies the transactions made by the URS and those the CIO made on his own account.

On the same day URS sold 195,000 shares of Charles River Labs, the CIO bought put options on his own account.

Figure 1. CIO Purchase of Put Options Raises Concerns. On the same day the URS sold 195,00 shares of Charles River Labs, the CIO purchased put options on the same stock.

| Date | URS Transactions | | | CIO's Transactions | | |
|----------|------------------|---------|--------------|--------------------|--|---------|
| | Action Taken | Shares | Price/ share | Action Taken | Shares | Value |
| 11/14/01 | Sold | 50,000 | \$30.61 | | | |
| 11/15/01 | Sold | 195,000 | 30.75 | Bought | 15 Put Contracts @ \$30 strike price with Dec 22,'01 expiration date | \$2,458 |
| 11/21/01 | | | | Sold | 15 Put Contracts @ \$30 strike price with Dec 22,'01 expiration date | \$ 992 |

Average daily trading volume for November 2001: 298,729 shares.

Figure 1 shows that on November 14 the URS sold 50,000 shares of stock in Charles River Labs, and on November 15 the remaining 195,000 URS shares were sold. On the same day that the larger amount of URS

shares were sold, the CIO also purchased 15 put option contracts for Charles Rivers Labs on his personal account.

The purchase of 15 put options gave the CIO the right to sell 1,500 shares of Charles River Labs in the future for \$30 per share. Thus, if the stock's market price declined below \$30, the CIO stood to make a significant profit, depending on the size of the decline because he could buy the stock below \$30 and get back \$30 from the option seller. However, if the stock price remained above \$30 per share, the contract would eventually expire on December 22, 2001 without any value.

The sale of a large amount of stock tends to push down the stock price. During November 2001, the average daily trading volume for Charles River Labs was about 300,000 shares. Thus, the sale by the URS was about 65 percent of the average daily trading volume of that stock. However, an unusually large volume of shares was traded on November 15, the day the CIO purchased put options. On that day, the URS trades represented 23 percent of the total daily volume.

In spite of the large volume of shares sold by the URS, the price of Charles River Labs did not decline significantly on November 15 and never dropped low enough to increase the value of the CIO's put options. Moreover, the price of the shares increased during the next few days and the CIO sold his options for a loss of \$1,466.

CIO Invested in Same Stock That Was Purchased By URS Fund Managers

We identified nine instances in which the CIO invested in the same companies in which URS fund managers purchased stock. In some cases, the CIO's personal trades occurred close to the same time that a fund manager purchased shares for the URS. The CIO's purchase of Grey Wolf, Inc. is one example. Figure 2 provides a side-by-side comparison of the trades made by the URS and by the CIO.

Some of the CIO's personal trades occurred close to the same time that a fund manager purchased shares for the URS.

Figure 2. CIO's Purchase of Grey Wolf at the Same Time as a URS Fund Manager Raises Concern. The CIO discussed Grey Wolf and other specific stocks with URS fund managers.

| | URS Transactions | | | CIO's Transactions | | |
|--------------------|------------------|-----------|--------------|--------------------|--------|--------|
| Date | Action | Shares | Price | Action | Shares | Price |
| 10/8/99 | Bought | 200,000 | \$2.31 | Bought | 1,000 | \$2.38 |
| 10/20/99 | Bought | 85,000 | 2.26 | | | |
| 10/21/99 | Bought | 105,000 | 2.34 | | | |
| 11/17/99 | | | | Sold | 1,000 | 3.25 |
| 12/2/99 | Bought | 48,000 | 2.80 | | | |
| 12/3/99 | Bought | 153,000 | 2.75 | | | |
| 12/6/99 | Bought | 257,000 | 2.75 | | | |
| 12/7/99 | Bought | 52,000 | 2.69 | | | |
| 12/9/99 | Bought | 53,000 | 2.63 | | | |
| 12/13/99 | Bought | 90,000 | 2.53 | | | |
| 12/14/99 | Bought | 45,000 | 2.56 | | | |
| 12/15/99 | Bought | 112,000 | 2.69 | | | |
| 1/10/00 | Bought | 100,000 | 2.92 | | | |
| 1/12/00 | Bought | 20,400 | 2.88 | | | |
| 7/19/00 to 9/28/00 | Sold | 1,320,400 | 4.38 to 5.75 | | | |

Average daily trading volume for October 1999: 838,852 shares.

The CIO reports that he had conversations with two URS fund managers about individual stocks.

The CIO reports that he had conversations about Grey Wolf and several other individual stocks with two URS fund managers. Although the CIO may have discussed individual stocks with other fund managers, we only compared the CIO's personal investments to the two with whom the CIO said he had discussed stocks. Including the case of Grey Wolf, described above, we identified a total of nine companies in which the CIO made a personal investment at roughly the same time that URS fund managers were investing in the companies for the fund. Most of the nine companies were small companies whose stock price could be affected by the purchase of shares by an institutional investor such as the URS. Each of the nine stocks is described in the Appendix.

The discussions between the CIO and URS fund managers are a concern because they may have provided the CIO with privileged information about the system's future investment in those companies.

Fund Manager Purchased Shares in a Company In Which the CIO Had Already Invested

The discussions between the CIO and a fund manager regarding individual stocks may have led the fund manager to purchase shares in a company in which the CIO already held shares. After the CIO purchased shares in Align Technology, Inc., he discussed the merits of the stock with a URS fund manager. The fund manager later purchased shares for the URS account which he manages. The following figure shows the transactions made by the CIO and by the URS in shares of Align Technology.

Discussions with a URS fund manager may have led one fund manager to purchase shares in a company in which the CIO already held shares.

Figure 3. A URS Fund Manager Invested In Align Technology After Discussing the Stock with the CIO. The CIO already owned shares of Align Technology when a URS fund manager purchased shares for the retirement fund.

| Date | URS Transactions | | | CIO's Transactions | | |
|---------|------------------|--------|-------------|--------------------|--------|-------------|
| | Action | Shares | Price/Share | Action | Shares | Price/Share |
| 9/27/01 | | | | Bought | 1,000 | \$2.50 |
| 12/4/01 | | | | Bought | 1,000 | 4.00 |
| 3/22/02 | Bought | 17,000 | \$4.51 | | | |
| 3/25/02 | Bought | 28,300 | 4.80 | | | |
| 3/26/02 | Bought | 1,900 | 5.02 | | | |
| 3/27/02 | Bought | 1,900 | 5.00 | | | |
| 4/3/02 | Bought | 1,000 | 4.99 | | | |
| 6/11/02 | Sold | 7,300 | 3.70 | | | |
| 7/1/02 | Sold | 3,900 | 3.54 | | | |
| 7/10/02 | Bought | 16,000 | 1.71 | | | |
| 7/11/02 | Bought | 17,400 | 1.68 | | | |
| 7/12/02 | Bought | 20,600 | 2.11 | | | |
| 7/15/02 | Bought | 20,600 | 2.20 | | | |

Average daily trading volume for March 2002: 170,350 shares.

By purchasing shares in a small company, a fund manager can put upward pressure on the price of the stock and provide a financial benefit to the CIO. For this reason, the CIO should avoid discussing his own investments with URS fund managers. The CIO has a role in the selection, oversight and retention of fund managers and should avoid

giving URS fund managers an opportunity to gain favor with the CIO by investing in a company in which the CIO already holds stock.

CIO's Investment Activities Appear to Be Conflicts of Interest and May Be Illegal

The prior section describes personal investments by the CIO that raise serious concerns. We identified a total of eleven investments made by URS fund managers that coincide with investments made by the CIO for his own account. See the Appendix for details regarding these eleven transactions that raise conflict of interest concerns. These activities appear to be inconsistent with the URS conflict of interest policies because of the CIO's role in managing the retirement fund and for helping decide about the selection and retention of the fund managers who invest portions of the fund. In addition, experts advised us that some of the CIO's personal trades may have been illegal because he possessed material, non-public information about the stock he traded.

The Retirement Board should investigate whether the CIO's personal investment activities constitute a violation of its conflict of interest policies. In addition, we recommend that the board strengthen its conflict of interest policies by: (1) placing restrictions on the personal investment activities of staff and board members who have access to privileged information; and, (2) limiting outside investment advisory services by its professional investment staff. Outside services refer to services provided that are beyond the scope of an individual's URS employment responsibilities. As it considers ways to strengthen its own policies, the board should examine the restrictions that other states have adopted.

URS Policies Prohibit Conflicts of Interest

In 1993 the Retirement Board passed a resolution governing conflicts of interest by board members and other fiduciary staff. The resolution states the following:

A "conflict of interest" exists whenever a Trustee, staff fiduciary, service provider, professional advisor or consultant, acting in that position, takes any action that is, or reasonably appears to be, influenced by considerations of personal gain or benefit rather than motivated by the interests of the Systems and their members and

Board members and staff must avoid not only actual fiduciary breaches of trust but also any reasonable appearance of a conflict of interest.

Fiduciaries may not use their positions at URS to obtain financial gain for themselves.

beneficiaries. The fundamental principle underlying these conflict of interest rules is that any Trustee or employee of the Systems ... occupies a special position of fiduciary trust and confidence such that he or she must studiously and conscientiously avoid not only actual fiduciary breaches of trust against the Systems, but also any reasonable appearance of a conflict of interest.

Furthermore, the conflict of interest policies prohibit using one's position for personal gain.

No Board member or staff fiduciary shall use his or her position with respect to the Board to obtain financial gain for himself or herself, any member of his or her household, or any business with which he or she is a member... .

Board Should Examine CIO Investment Activities. The board's Conflict of Interest policy provides that the board has sole discretion to determine if the policy has been violated. While the board has not yet considered the issues, in our opinion the above policies appear to prohibit many of the CIO's personal investment activities described previously in this report.

The CIO should avoid even the appearance of a conflict of interest because he is responsible for making crucial decisions regarding the investment of the retirement fund. Sometimes the CIO must decide when to purchase or sell specific investments. In addition, most of the retirement fund is managed by outside fund managers and the CIO plays a significant role in the selection and retention of those who oversee specific portions of the fund. Because of these important responsibilities, the CIO should avoid the appearance that his personal interests may affect his decisions—both with regard to the investment of fund and the selection of fund managers.

URS Should Review Other States' Policies

We contacted the retirement systems of some other states to learn whether they had policies addressing the personal investments and outside employment of staff with access to privileged information. The purpose of such policies at URS and other pension systems is to ensure that even the appearance of conflicts of interest is avoided. Generally, we found other states have more restrictions than the URS on the personal

investment activities of staff. In contrast, policies addressing outside services or employment by staff at URS and other pension systems are similar. However, it is difficult to know how different retirement systems apply their policies.

Some other states require their investment staff to disclose their personal investments each year.

Other States Require Disclosure and Place Limits on Staff's Personal Investment Activities. There are two methods that other states use to prevent their investment staff from making inappropriate personal investments. The first is the disclosure of personal investment activities. We found that the state retirement systems of Arizona, Colorado, New Mexico, Virginia, Washington, and Wisconsin require employees with fiduciary responsibility to annually disclose all of their personal investments in order to verify compliance with conflict of interest policies. A second approach is to limit the time during which staff may invest in the same securities in which the system is investing. For example, the retirement systems in Missouri and Arizona employ blackout periods that require employees to avoid investing in specific securities within a certain time period during which the system is investing in those securities.

URS Should Consider Limiting Outside Investment Advisory Services by Professional Investment Staff. Most of the retirement systems we surveyed also require staff to fully disclose outside services or employment to either the board, human resource department, or internal audit staff. The URS policy on outside services or employment has similar notification and approval requirements to those we found in other states. However, it's difficult to know how different states' policies may be applied to key personnel who have access to privileged information.

During our review of the URS conflict of interest policies, we learned that in 1999 and 2000, the CIO provided investment advisory services to a number of private clients for a fee. Consistent with URS policy, the CIO disclosed his outside services to URS management and reported that it would not conflict with his job as CIO. In 2000, the CIO stopped providing private investment advisory services, but he was told that policies do not prohibit him from resuming the business if he chooses to do so.

Although the business was properly disclosed to URS, it still raises concerns because the CIO's employment at URS provides him access to privileged information. We have no evidence that the CIO inappropriately used privileged information to benefit any of his clients.

In 1999 and 2000 the CIO provided investment advisory services to a number of private clients for a fee.

The Division of Securities is considering the legal issues surrounding the CIO's personal investments.

Still, his outside activities could provide the appearance that he is using his position at the URS to benefit private individuals seeking his professional services. For this reason, we believe the board should consider restricting professional investment staff from providing outside investment advisory services.

CIO's Investments May Be a Form of Insider Trading

We invited the Utah Division of Securities and Mr. DeWitt Bowman, a former CIO for the California Public Employees Retirement System, to examine each instance in which the CIO made an investment that overlapped an investment made by the URS. Both the division and our consultant said that some of the personal investments made by the CIO might be a form of insider trading. George Robison, the Director of Licensing and Compliance, Utah Division of Securities noted:

To date, the areas of concern that are known to the Division that appear to be violations of the law are: trading on insider or non-public information; breaching his fiduciary duty as the manager of the Utah Retirement Systems; acting as an unlicensed investment adviser representative; and operating an investment advisory firm without notice filing with the Division.

Similarly, our consultant, DeWitt Bowman said the following regarding the CIO's investment in Charles River Labs:

Although I am not an attorney, I am quite certain the specific action you have described would be considered to be "front running" and forbidden under SEC regulations if practiced by an investment management firm. ... The action appears to stem from privileged information, namely the knowledge that a large security transaction was taking place which would have the potential to affect the market price of the involved security, and that an attempt was made to profit personally on this knowledge before it became known to the markets at large.

With regard to the CIO's personal investments in general, Mr. Bowman states that:

...the pattern of [the CIO's] personal security transactions ... created the potential for serious conflicts of interest which could

have resulted in illegal or inappropriate gains for [the CIO] and potential embarrassment for URS... .

This review of the CIO's personal investments was conducted with the assistance of the Utah Division of Securities. As a result, the division is already informed about the details of the case. The division has told us that they will take any appropriate legal action regarding this matter after its investigation is completed.

Recommendations

1. We recommend that the Utah Retirement Board determine if the CIO's personal investments violated its existing conflict of interest policy.
2. We recommend that the Utah Retirement Board clarify its conflict of interest policies and consider adopting restrictions similar to those used by other retirement systems that impose specific reporting requirements and blackout periods for the personal investments made by staff.
3. We recommend that the Utah Retirement Board consider strengthening its conflict of interest policy to limit outside investment advisory services by its professional investment staff.

This Page Left Blank Intentionally

Appendix

Comparison of URS Investments with Personal Investments of CIO

The following table compares the investments made by URS fund managers to the personal investments made by the Chief Investment Officer.

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|---|---------|-----------------|--------|-------------------|--------|
| Align Technology, Inc. | | | | | |
| | 9/27/01 | | | Bought 1,000 | \$2.50 |
| | 12/4/01 | | | Bought 1,000 | \$4.00 |
| | 3/22/02 | Bought 17,000 | \$4.51 | | |
| | 3/25/02 | Bought 28,300 | 4.80 | | |
| | 3/26/02 | Bought 1,900 | 5.02 | | |
| | 3/27/02 | Bought 1,900 | 5.00 | | |
| | 4/3/02 | Bought 1,000 | 4.99 | | |
| | 6/11/02 | Sold 7,300 | 3.70 | | |
| | 7/1/02 | Sold 3,900 | 3.54 | | |
| | 7/10/02 | Bought 16,000 | 1.71 | | |
| | 7/11/02 | Bought 17,400 | 1.68 | | |
| | 7/12/02 | Bought 20,600 | 2.11 | | |
| | 7/15/02 | Bought 20,600 | 2.20 | | |
| <p>Note: During the month of March 2002, the average daily trading volume of Align Technology Inc. shares was 170,350 shares per day.</p> | | | | | |

| | | | | | |
|---|----------|--------------|---------|--|---------|
| Charles River Laboratories International, Inc. | | | | | |
| | 11/14/01 | Sold 50,000 | \$30.61 | | |
| | 11/15/01 | Sold 195,396 | 30.75 | Bought 15 Put Contracts @ \$30 strike price | \$2,458 |
| | 11/21/01 | | | Sold 15 Put Contracts @ \$30 strike price | 992 |
| <p>Note: During the Month of November 2001, the average daily trading volume for Charles River Labs was 298,729 shares per day.</p> | | | | | |

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|-------|------|-----------------|-------|-------------------|-------|
|-------|------|-----------------|-------|-------------------|-------|

Corillian Corp.

| | | | | | |
|--|----------|----------------|--------|--------------|--------|
| | 10/10/01 | Bought 50,000 | \$1.85 | | |
| | 10/11/01 | Bought 43,500 | 2.46 | | |
| | 10/12/01 | Bought 126,400 | 2.71 | | |
| | 10/15/01 | Bought 18,836 | 2.65 | | |
| | 10/16/01 | Bought 9,100 | 2.85 | | |
| | 10/17/01 | Bought 4,500 | 2.87 | | |
| | 10/18/01 | Bought 6,900 | 2.83 | | |
| | 10/19/01 | Bought 79,500 | 2.88 | | |
| | 10/23/01 | Bought 12,700 | 3.00 | | |
| | 10/24/01 | Bought 13,300 | 3.17 | | |
| | 10/29/01 | Bought 10,300 | 2.78 | | |
| | 10/31/01 | Bought 1,100 | 2.50 | | |
| | 11/12/01 | Bought 9,100 | 2.73 | | |
| | 11/30/01 | Bought 5,700 | 2.57 | | |
| | 12/3/01 | Bought 6,100 | 2.71 | | |
| | 12/4/01 | Bought 11,700 | 2.89 | | |
| | 12/5/01 | Bought 5,476 | 2.96 | | |
| | 12/6/01 | | | Bought 1,000 | \$2.90 |
| | 12/7/01 | Bought 56,300 | 3.68 | | |
| | 12/10/01 | Bought 35,200 | 5.24 | | |
| | 12/11/01 | Bought 13,600 | 5.07 | | |
| | 12/26/01 | Sold 4,600 | 4.50 | | |
| | 1/3/02 | | | Sold 1,000 | \$3.12 |
| | 1/4/02 | Sold 6,200 | 3.89 | | |
| | 1/7/02 | Sold 1,100 | 3.75 | | |
| | 1/14/02 | Sold 7,200 | 3.00 | | |
| | 1/23/02 | Sold 2,500 | 2.82 | | |
| | 1/25/02 | Sold 2,800 | 2.95 | | |
| | 1/31/02 | Sold 8,800 | 2.67 | | |
| | 2/1/02 | Sold 2,200 | 2.47 | | |
| | 3/14/02 | Sold 2,500 | 3.10 | | |
| | 3/15/02 | Sold 40,000 | 2.72 | | |
| | 4/1/02 | Sold 17,500 | 2.75 | | |
| | 6/19/02 | Sold 1,700 | 2.25 | | |
| | 6/20/02 | Sold 1,600 | 2.27 | | |
| | 6/21/02 | Sold 400 | 2.25 | | |
| | 7/11/02 | Bought 100,000 | 1.60 | | |
| | 7/12/02 | Bought 32,000 | 1.61 | | |

Note: On 6/30/02 the URS fund manager was the largest institutional shareholder of Corillian with 15.5 percent of the outstanding shares. The average daily trading volume for Corillian during December 2001, was 426,825 shares a day. During the month of January 2002, the average daily trading volume of Corillian shares was 208,290 shares per day.

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|-------|------|-----------------|-------|-------------------|-------|
|-------|------|-----------------|-------|-------------------|-------|

Digimarc Corp.

| | | | | | |
|--|----------|----------------|---------|------------|---------|
| | 9/20/01 | | | Bought 300 | \$12.12 |
| | 10/11/01 | Bought 75,000 | \$12.15 | | |
| | 10/12/01 | Bought 15,300 | 12.35 | | |
| | 10/15/01 | Bought 27,100 | 12.30 | | |
| | 10/16/01 | Bought 16,000 | 12.22 | | |
| | 10/17/01 | Bought 25,000 | 13.30 | | |
| | 10/19/01 | Bought 75,000 | 11.70 | | |
| | 10/22/01 | Bought 13,400 | 12.77 | | |
| | 10/25/01 | Bought 3,842 | 13.18 | | |
| | 10/30/01 | Bought 102,008 | 13.15 | | |
| | 11/12/01 | | | Sold 300 | \$15.10 |
| | 11/14/01 | Sold 2,200 | 16.00 | | |
| | 11/15/01 | Sold 400 | 16.05 | | |
| | 11/16/01 | Sold 14,000 | 15.06 | | |
| | 12/4/01 | Sold 1,100 | 18.54 | | |
| | 12/24/01 | Bought 12,100 | 18.25 | | |
| | 12/27/01 | Bought 300 | 17.99 | | |

Note: As of June 30, 2002, a URS fund manager was the largest institutional shareholder of Digimarc, with 25% of the outstanding shares. During the month of October 2001, the average daily trading volume of Digimarc shares was 101,900 shares per day. During the month of November 2001, the average daily trading volume of Digimarc was 66,805 shares per day.

Electro Scientific Industries

| | | | | | |
|--|---------|--------------|---------|------------|---------|
| | 2/21/01 | Bought 5,300 | \$31.00 | | |
| | 2/22/01 | Bought 5,500 | 30.97 | | |
| | 2/23/01 | Bought 5,500 | 30.71 | | |
| | 2/26/01 | Bought 5,500 | 30.75 | | |
| | 2/28/01 | Bought 5,500 | 29.50 | | |
| | 3/1/01 | Bought 2,500 | 27.13 | | |
| | 3/12/01 | Bought 9,000 | 30.88 | | |
| | 3/23/01 | | | Bought 200 | \$28.00 |
| | 4/9/01 | Sold 700 | 27.75 | | |
| | 4/10/01 | Sold 4,700 | 28.60 | | |
| | 4/11/01 | Sold 10,200 | 32.63 | | |
| | 4/12/01 | Sold 3,400 | 33.50 | | |
| | 4/16/01 | Sold 2,100 | 34.41 | | |
| | 4/18/01 | Sold 4,800 | 34.41 | | |
| | 4/18/01 | Sold 8,900 | 35.61 | | |
| | 4/19/01 | Sold 4,000 | 34.85 | | |
| | 4/24/01 | | | Sold 200 | \$35.00 |

Note: During the month of March 2001, the average daily trading volume of Electro Scientific shares was 279,086 shares per day.

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|-------|------|-----------------|-------|-------------------|-------|
|-------|------|-----------------|-------|-------------------|-------|

Grey Wolf, Inc.

| | | | | | |
|--|------------|----------------|--------------|--------------|--------|
| | 10/8/99 | Bought 200,000 | \$2.31 | Bought 1,000 | \$2.38 |
| | 10/20/99 | Bought 85,000 | 2.26 | | |
| | 10/21/99 | Bought 105,000 | 2.34 | | |
| | 11/17/99 | | | Sold 1,000 | \$3.25 |
| | 12/2/99 | Bought 48,000 | 2.80 | | |
| | 12/3/99 | Bought 153,000 | 2.75 | | |
| | 12/6/99 | Bought 257,000 | 2.75 | | |
| | 12/7/99 | Bought 52,000 | 2.69 | | |
| | 12/9/99 | Bought 53,000 | 2.63 | | |
| | 12/13/99 | Bought 90,000 | 2.53 | | |
| | 12/14/99 | Bought 45,000 | 2.56 | | |
| | 12/15/99 | Bought 112,000 | 2.69 | | |
| | 1/10/00 | Bought 100,000 | 2.92 | | |
| | 1/12/00 | Bought 20,400 | 2.88 | | |
| | 7/19/00 to | | | | |
| | 9/28/00 | Sold 1,320,400 | 4.38 to 5.75 | | |

Note: During the month of October 1999, the average daily trading volume of Grey Wolf Inc. shares was 838,852 shares per day.

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|--|----------|-----------------|---------|-------------------|--------|
| Loral Space and Communications, Ltd. | | | | | |
| | 2/15/00 | Bought 75,000 | \$16.50 | | |
| | 3/30/00 | Bought 80,000 | 10.31 | | |
| | 4/4/00 | Bought 20,000 | 10.00 | | |
| | 4/5/00 | Bought 20,000 | 9.50 | | |
| | 4/7/00 | Bought 100,000 | 10.13 | | |
| | 4/14/00 | Bought 100,000 | 8.20 | | |
| | 5/24/00 | Bought 60,000 | 7.69 | | |
| | 6/13/00 | Bought 40,000 | 7.32 | | |
| | 6/19/00 | Bought 85,000 | 6.45 | | |
| | 8/3/00 | Sold 12,200 | 6.38 | | |
| | 9/13/00 | Bought 10,000 | 6.75 | | |
| | 9/22/00 | Bought 120,000 | 5.99 | | |
| | 1/29/01 | Sold 42,400 | 5.79 | | |
| | 1/31/01 | Sold 10,600 | 5.85 | | |
| | 3/13/01 | | | Bought 1,000 | \$2.81 |
| | 3/22/01 | | | Bought 1,000 | \$2.37 |
| | 6/11/01 | | | Sold 2,000 | \$3.28 |
| | 8/16/01 | Sold 3,600 | 1.77 | | |
| | 8/20/01 | Sold 4,200 | 1.79 | | |
| | 8/21/01 | Sold 25,400 | 1.74 | | |
| | 8/22/01 | Sold 10,800 | 1.76 | | |
| | 8/24/01 | Sold 83,400 | 1.87 | | |
| | 8/27/01 | Sold 23,700 | 1.95 | | |
| | 8/28/01 | Sold 17,100 | 1.88 | | |
| | 8/28/01 | Sold 3,600 | 1.85 | | |
| | 8/29/01 | Sold 9,300 | 1.82 | | |
| | 8/31/01 | Sold 21,800 | 1.86 | | |
| | 9/4/01 | Sold 14,500 | 1.94 | | |
| | 9/5/01 | Sold 3,600 | 1.81 | | |
| | 9/5/01 | Sold 18,100 | 1.77 | | |
| | 9/6/01 | Sold 16,300 | 1.71 | | |
| | 9/6/01 | Sold 7,400 | 1.69 | | |
| | 9/7/01 | Sold 27,300 | 1.71 | | |
| | 9/10/01 | Sold 29,000 | 1.70 | | |
| | 9/17/01 | Sold 43,500 | 1.93 | | |
| | 9/17/01 | Sold 9,000 | 1.95 | | |
| | 9/18/01 | Sold 52,600 | 1.70 | | |
| | 9/19/01 | Sold 100 | 1.76 | | |
| | 10/1/01 | Sold 51,000 | 1.30 | | |
| | 10/2/01 | Sold 50,000 | 1.28 | | |
| | 10/3/01 | Sold 50,000 | 1.28 | | |
| | 10/4/01 | Sold 49,000 | 1.28 | | |
| | 10/17/01 | Sold 1,600 | 1.39 | | |
| | 10/18/01 | Sold 11,400 | 1.52 | | |
| | 10/19/01 | Sold 5,900 | 1.50 | | |
| | 10/22/01 | Sold 800 | 1.49 | | |
| | 10/23/01 | Sold 800 | 1.50 | | |
| Note: During the month of August 2001, the average daily trading volume of Loral Space & Comm. Inc. shares was 1,663,283 shares per day. | | | | | |

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|-------|------|-----------------|-------|-------------------|-------|
|-------|------|-----------------|-------|-------------------|-------|

Micron Technologies, Inc.

| | | | | |
|---------|-------------|----------|------------------------|------------|
| 3/1/00 | Sold 60,000 | \$105.00 | | |
| 3/10/00 | Sold 20,000 | 108.00 | | |
| 3/13/00 | Sold 20,000 | 111.13 | | |
| 3/13/00 | Sold 20,000 | 115.69 | | |
| 3/14/00 | Sold 40,000 | 125.33 | Purchased 5 Put Option | \$2,695.00 |
| 3/14/00 | | | Sold 5 Put Option | \$4,470.59 |
| 3/20/00 | Sold 10,000 | 129.13 | | |
| 3/20/00 | Sold 30,000 | 135.50 | | |
| 4/18/00 | Sold 10,000 | 125.00 | | |
| 4/25/00 | Sold 10,000 | 129.06 | | |

Note: On 12/31/99, the URS held 220,000 shares of Micron Technologies. During the month of March 2000, the stock's average daily trading volume was 13,206,374 shares per day.

Orbital Sciences Corp

| | | | | |
|----------|---------------|--------|--------------|--------|
| 5/18/01 | Bought 10,000 | \$3.76 | | |
| 6/4/01 | Bought 10,000 | 3.80 | | |
| 6/5/01 | Bought 10,000 | 3.80 | | |
| 6/6/01 | Bought 28,800 | 3.54 | | |
| 6/7/01 | Bought 1,000 | 3.48 | | |
| 6/12/01 | Bought 200 | 3.48 | | |
| 9/19/01 | Bought 10,000 | 3.51 | | |
| 9/20/01 | Bought 10,000 | 3.42 | | |
| 9/25/01 | | | Bought 1,000 | \$2.51 |
| 11/29/01 | Bought 5,600 | 4.15 | | |
| 2/11/02 | | | Sold 1,000 | \$5.28 |
| 2/26/02 | Sold 11,200 | 5.88 | | |
| 3/1/02 | Sold 2,800 | 5.95 | | |
| 3/4/02 | Sold 14,000 | 6.08 | | |
| 3/12/02 | Sold 55,300 | 7.03 | | |
| 4/19/02 | Sold 5,600 | 4.98 | | |
| 4/24/02 | Sold 43,700 | 5.64 | | |
| 4/24/02 | Sold 5,600 | 5.80 | | |
| 5/24/02 | Sold 36,500 | 7.37 | | |
| 5/30/02 | Sold 17,000 | 7.62 | | |
| 5/31/02 | Sold 4,000 | 7.80 | | |
| 6/3/02 | Sold 1,200 | 7.58 | | |
| 6/5/02 | Sold 700 | 7.43 | | |
| 6/6/02 | Sold 2,400 | 7.59 | | |
| 6/7/02 | Sold 2,500 | 7.41 | | |
| 6/10/02 | Sold 500 | 7.75 | | |
| 6/13/02 | Sold 1,200 | 7.80 | | |
| 6/25/02 | Sold 700 | 7.68 | | |
| 6/28/02 | Sold 13,500 | 7.66 | | |
| 7/1/02 | Sold 20,100 | 7.74 | | |
| 7/2/02 | Sold 5,200 | 7.46 | | |
| 7/3/02 | Sold 3,300 | 7.41 | | |
| 7/5/02 | Sold 2,300 | 7.40 | | |
| 8/2/02 | Bought 28,400 | 2.85 | | |
| 8/6/02 | Bought 1,200 | 3.11 | | |
| 8/7/02 | Bought 1,400 | 3.11 | | |
| 8/30/02 | Bought 2,100 | 3.73 | | |

Note: On 12/31/00 the URS held 795,500 shares in Orbital Sciences. By 12/31/01 the URS held 880,600 shares which amounted to 6.4 percent of the total outstanding shares of Orbital Sciences Corp. During February 2002, the average daily trading volume was 325,553 shares per day.

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|-------|------|-----------------|-------|-------------------|-------|
|-------|------|-----------------|-------|-------------------|-------|

Paradigm Genetics, Inc.

| | | | | | |
|--|----------|----------------|--------|--------------|--------|
| | 10/17/01 | Bought 522,300 | \$5.50 | | |
| | 10/30/01 | Bought 9,100 | 4.94 | | |
| | 10/31/01 | Bought 10,400 | 4.90 | | |
| | 11/6/01 | Bought 21,400 | 5.23 | | |
| | 11/7/01 | Bought 10,600 | 5.85 | | |
| | 11/7/01 | Bought 10,500 | 5.95 | | |
| | 12/4/01 | Bought 27,400 | 4.90 | | |
| | 12/28/01 | Bought 17,600 | 5.42 | | |
| | 12/28/01 | Bought 5,900 | 5.28 | | |
| | 12/31/01 | Bought 2,400 | 5.63 | | |
| | 1/23/02 | Sold 6,300 | 3.60 | | |
| | 1/25/02 | Sold 5,000 | 3.85 | | |
| | 3/21/02 | | | Bought 2,000 | \$1.60 |
| | 5/10/02 | Sold 37,700 | 1.61 | | |
| | 5/21/02 | Sold 29,500 | 1.40 | | |
| | 5/30/02 | Sold 12,800 | 1.24 | | |
| | 7/11/02 | Bought 151,000 | 1.22 | | |

Note: On June 30, 2002 a URS fund manager was the largest single institutional investor of Paradigm Genetics with 22.5% of the outstanding shares. During the month of January 2002, the average daily trading volume of Paradigm Genetics shares was 375,110 shares per day.

| Stock | Date | URS Transaction | Price | CIO's Transaction | Price |
|---------------------------------------|----------|-----------------|--------|-------------------|--------|
| Petro Heat and Power Co., Inc. | | | | | |
| | 1/2/97 | Bought 15,421 | \$6.12 | | |
| | 1/23/97 | Bought 83,400 | 5.88 | | |
| | 1/24/97 | Bought 35,000 | 5.88 | | |
| | 1/27/97 | Bought 4,500 | 5.88 | | |
| | 1/28/97 | Bought 25,000 | 5.88 | | |
| | 1/30/97 | | | Bought 2,700 | \$5.77 |
| | 2/3/97 | Bought 243,300 | 5.63 | | |
| | 4/1/97 | Bought 22,601 | 3.44 | | |
| | 6/19/97 | Bought 37,200 | 3.13 | | |
| | 6/23/97 | Bought 62,800 | 3.13 | | |
| | 6/24/97 | Bought 26,000 | 2.83 | | |
| | 6/25/97 | Bought 51,512 | 2.71 | | |
| | 6/26/97 | Bought 22,488 | 2.91 | | |
| | 6/27/97 | Bought 19,000 | 2.88 | | |
| | 6/30/97 | Bought 3,800 | 2.88 | | |
| | 7/1/97 | Bought 28,810 | 2.72 | | |
| | 7/2/97 | Bought 26,000 | 2.88 | | |
| | 7/3/97 | Bought 4,500 | 2.88 | | |
| | 7/23/97 | | | Sold 2,700 | \$2.96 |
| | 8/11/97 | Bought 600 | 3.00 | | |
| | 8/12/97 | Bought 4,500 | 3.00 | | |
| | 8/14/97 | Bought 2,000 | 3.00 | | |
| | 8/15/97 | Bought 500 | 3.00 | | |
| | 8/21/97 | Bought 19,100 | 3.00 | | |
| | 8/22/97 | Bought 1,000 | 3.00 | | |
| | 8/25/97 | Bought 12,500 | 3.00 | | |
| | 8/26/97 | Bought 6,500 | 3.00 | | |
| | 8/27/97 | Bought 10,000 | 3.00 | | |
| | 10/1/97 | Bought 34,208 | 3.06 | | |
| | 12/31/97 | Bought 3,500 | 2.38 | | |
| | 5/14/98 | Bought 32,000 | 1.59 | | |
| | 10/2/98 | Sold 5,000 | 1.38 | | |
| | 10/21/98 | Sold 103,000 | 1.03 | | |
| | 10/22/98 | Sold 17,000 | 1.03 | | |
| | 10/23/98 | Sold 16,500 | 1.44 | | |

Note: At the time the CIO purchased his shares a URS fund manager was one of the largest shareholders in the company with nearly 15 percent of the firm's outstanding shares. On January 1, 1997 the URS held 629,376 shares of Petro Heat and Power. By the end of 1998, the shares held by URS represented 6.2 percent of the company's outstanding shares.

This Page Left Blank Intentionally

Agency Response

February 5, 2003

Wayne L. Welsh
Legislative Auditor General
130 State Capitol
PU Box 140151
Salt Lake City, 841 14-0151

Mr. Welsh:

This letter is provided by URS in response to your Report No. 2003-0 1 “A Review of Possible Staff Conflicts of Interest at the Utah Retirement Systems”.

Background

In January 2002, the Legislative Auditor General began an audit of URS, with an emphasis on its investment practices and policies. In October 2002, the Legislative Auditor and Staff met with counsel for URS to inform URS of certain findings by the Auditor General which raised serious ethical and other concerns with respect to activities of the chief investment officer of URS (CIO). At that time URS informed the auditor of its desire and obligation to appoint counsel to independently investigate these concerns. During the period of October-December, URS, Legislative Auditor and Legislative Counsel conferenced to establish a means by which the Auditor’s records could be furnished to the independent Counsel. In December, a separate meeting was held with a representative from the auditor’s office, counsel for URS, and independent counsel selected by URS, for the auditor to furnish the information which would assist the independent counsel in its investigation of any potential wrongdoing.

Review of Legislative Reports

The Utah Retirement Systems (URS) has reviewed the Legislative Auditor’s Report under the following terms and conditions: the director, chief investment officer, legal counsel, and 3 Board members (the President, Vice-President and ex-officio member) were furnished a confidential draft on Thursday, January 23, 2003 and asked to furnish its response to the Legislative Auditor General verbally by Monday, January 27 and in writing by January 28. URS furnished its preliminary response in writing by means of a confidential draft memo dated January 27, 2003.

The Legislative Auditor General then furnished a second draft version on Friday January 31, to all members of the board, the director, the chief investment officer and his counsel, and URS legal counsel. URS was asked to furnish its response in writing by February 4, 2003.

The following comments represent the above individuals' best efforts to respond in this limited time frame.

URS is Conducting an Independent Investigation into Issues Raised by the Report

The independent counsel is proceeding with its investigation and is within a few weeks of furnishing a final report to URS.

URS wants to make it clear that its ultimate goal is identical to that of the Legislative Auditor, and that is to ensure that URS is operating in a manner consistent with its fiduciary obligations and that anyone who acts in a manner inconsistent with, or in violation of applicable ethical and statutory standards is appropriately disciplined. URS is also certain that the auditor and the securities division, like URS, seek assurance that the facts underlying any claim are well grounded, accurate, and consistent among all investigating parties. Since receiving the Report, URS has been allowed to comment on factual representations contained in the report which would serve as the basis upon which the Board itself might take action. During the process of this investigation, material differences of relevant facts and opinions from those contained in an earlier draft report were discovered, and furnished to the Auditor. The Auditor agreed to make certain changes which he was able to independently verify. These are reflected in this final report. Since URS has now retained counsel to conduct the independent investigation and that investigation has not been concluded, URS is not in a position to formally comment on every potential finding or issue raised in the audit report. However, at the conclusion of its independent investigation, URS intends to take any necessary action in accordance with the findings and URS policies and rules.

In order to ensure the integrity of the URS independent investigation and all other investigations taking place, and with consideration for the due process rights of the accused, URS will have no further public comment on the allegations pertaining to the CIO in the Report until the conclusion of the investigations.

URS Response to the Recommendations in the Report

The Legislative Auditor General has made three recommendations with which URS agrees irrespective of the outcome of the various investigations.

(1) Even before receiving the recommendation, the Board was reviewing the conflict of interest and ethics policies used not only by other states but by the private investment manager! broker community with a view to updating and improving the existing policies and will report those to the appropriate legislative oversight committees.

(2) As stated earlier, URS has retained independent legal counsel specifically for the purpose of determining whether the CIO's personal investments violated its conflict of interest policy. In addition, while not included in the auditor's recommendations, the Board's investigation will extend also to other potential violations of the ethics code or fiduciary obligations.

(3) As part of its review of its ethics and conflict of interest policies, URS is already discussing and will establish policies prohibiting outside investment advisory services by professional investment staff.

The Retirement Fund and Beneficiaries Have Not Been Harmed By the Alleged Activities

There appears to be no allegation or evidence in the Report that the retirement fund itself lost money because of the alleged wrongdoings by the CIO. URS would like to inform the beneficiaries, participating employers and the public at large of that fact.

URS appreciates this opportunity to respond and will, as soon as possible, complete its investigation and furnish its final policy recommendations to the appropriate parties.

Sincerely

Robert V. Newman, Executive Director

February 6, 2003

BY HAND DELIVERY

Honorable Martin R. Stephens
Honorable Al Mansell
Honorable Mike Dmitrich
Honorable Brad King
Audit Subcommittee
303 State Capitol
Salt Lake City, Utah 84114

Re: Response to Auditor General's Report Entitled "Review of Possible Staff Conflicts of Interest at the Utah Retirement Systems"

Dear Members of the Audit Subcommittee:

This letter is written on behalf of our client, Richard Cherry, the chief Investment Officer for the Utah Retirement Systems (referred to as "the CIO") in response to the Report Number 2003-01 of the Office of Legislative Auditor General ("Report").

Inexcusably, information contained in the Report was leaked to the press one week before the Report was to be delivered to the Legislature. One can only ask what is the motive of those who leaked the information and why are they attempting to play politics with the URS. In the course of doing so, they have unjustly maligned a dedicated public servant with an unblemished record of 22 years' service to the Utah Retirement Systems.

During the six years covered by the Auditors' Report, 1997 through 2002, the CIO personally invested in 96 different securities, eleven of which were among the hundreds, if not thousands, of securities purchased or sold by professional fund managers for the URS portfolio. Investing in these eleven securities did not benefit the CIO personally. The net result of the CIO's trading in these eleven securities was a loss to him of \$1,923.00.

Contrary to the innuendo in the Auditor General's Report, the URS fund was not negatively affected in any way by the CO's personal investments. The CIO's trading in the eleven securities had no impact whatsoever on the retirement fund nor did he breach any duty owed to the Utah Retirement Systems.

The Utah Retirement Systems is fundamentally sound. In a disastrous economy, the worst since the Great Depression, the URS has performed considerably better than average. The paper value of its investment portfolio has decreased, but not as much as other public retirement funds. For the 3 year period ending September 30, 2002, performance of the URS ranks in the top third of public retirement funds, as reported by Callan Associates. This is due to its dedicated Board and staff, good consultants and professional managers, and sound investment policies.

No statute, regulation, or policy prohibits the Board or the staff of the URS from personally investing in securities held by the URS so long as there is no harm to the URS or a conflict of interest. Indeed, the Code of Ethics/Conflict of Interest statement for URS specifically recognizes the right to make personal investments. It provides:

Whereas, the Board also finds that it is equally important that persons of competence and integrity be encouraged to serve the Systems. Accordingly, the standards of conduct established under this Code of ethics should be interpreted and understood so as not to unreasonably frustrate or impede the recruitment and retention by the Systems of those persons best qualified to serve them and their members and beneficiaries. To that end, the Systems' professional advisors~ and consultants, their administrative staff employees, and particularly the members of their Board of Trustees, who are essentially volunteers, should not be denied the opportunity generally available to all other citizens to acquire and advance their private economic interests, except in circumstances in which a conflict of interest with the Systems would foreseeably result.

It is certainly legitimate for the Auditor General to pose the question whether there should be stricter policies governing personal investments by the URS Board and staff in regard to securities held in the name of the URS. Only a few states have such policies. It appears from the Report that the majority of states, including Utah, do not.

But the Report raises the issue without discussing the pros and cons of such restrictions. The biggest negative is that it may be impossible to attract the quality people one would want to serve on the Board and senior staff if they are prohibited in investing in a significant part of the market since the fund managers are presumably trading in the better securities available on the market. Many believe that fund managers should be personally invested in the same securities as they hold in their portfolios to make sure they are personally aligned with their clients. The same argument could be made for the Board and staff of the URS. Because of the Auditors' erroneous assumptions and conclusions about the nature of the relationship between the fund managers and members of the URS staff, the Report merely begs the question of whether such restrictions are desirable.

The Auditors' Report demonstrates a fundamental misunderstanding of the way the URS operates and the role of the CIO. This led to a number of unfortunate conclusions and unfounded speculation on the part of the authors and others quoted in the Report.

One of the fundamental failings of the Report lies in its misunderstanding of the role of the CIO in the hiring, monitoring, and firing of professional fund managers. On at least six occasions the Report states that the CIO is responsible for directing and controlling the selection, monitoring, and firing of outside investment managers. The Auditors' Report is simply wrong and, if they had done an adequate investigation, they would have known better.

The Executive Director, not the CIO, is ultimately responsible under the statute for the hiring and firing of outside investment managers. The process works as follows: If the URS Board authorizes the hiring of an additional fund manager, the URS outside consultant, Callan Associates, is asked to prepare a list of approximately six candidates. Callan Associates is one of the, largest and best respected investment consulting firms in the country. Callan has served as consultant to the URS for many years. Callan will review its database of fund managers and identify six candidates that meet the criteria for the particular type of investment mandate the URS desires (*e.g.*, small cap, mid cap, mixed, etc.). Callan then presents the six candidates to the URS staff (in the case of securities funds, this would include the CIO, Deputy Director, and the Trader/Analyst). Staff then identify the top three candidates and they are invited to make a presentation to the URS Board, Executive Director, staff, and Callan Associates. Following the presentations, the group discusses the merits of the candidates and, with the benefit of this input, the Executive Director makes the hiring decision. The Auditors should have known this process since they sat in on more than one search for a fund manager. If the Auditor General's staff had taken the time to interview Callan Associates, they would not have concluded that the CIO is responsible to "control the recruitment and selection of the systems' fund managers."

Similarly, once the fund managers are hired, they are given certain performance benchmarks. For example, these would include being in the 45th percentile of similar funds and exceeding the relevant index (such as the Russell 2500) on a rolling 5-year average. Callan Associates monitors the performance of the fund managers on behalf of the URS and reports quarterly to the Board and staff. Continued employment for fund managers is driven by the performance numbers, not by subjective criteria. If the fund managers do not meet their benchmarks, they are terminated. The Executive Director, with the collaborative input of the Board, staff and consultants, is statutorily responsible for the decision to fire fund managers. The failure of the Auditor General's staff to understand how the hiring and firing of fund managers actually operates is inexcusable because it led to the erroneous conclusion that fund managers may have been providing inside information to the CIO in order to obtain his favor and keep their jobs.

This conclusion by the Auditor's Report is even more inexcusable. The Report speculates, without any evidence whatsoever: "The discussions between the CIO and the URS fund managers are a concern because they *may have provided* the CIO with privileged information about the Systems' future investments in those companies." (Emphasis added.) The CIO candidly admitted to the Auditor's staff that he (along with the Board, other staff members, and Callan) had free-ranging discussions from time to time with fund managers about the economy and the market in general, particular segments of the economy, and particular stocks that managers thought were interesting. This is an integral part of the management of the URS.

The CIO made it clear to the Auditor's staff, however, that the fund managers *never* told him what their trading strategies were. They *never* told him in advance that they had decided to buy a particular stock, or the dates when they planned to buy, or how much stock they hoped to buy, or what their price sensitivities were. If the Auditor's staff had simply taken the time to interview the fund managers, they could have confirmed these facts and avoided making the speculative allegations in the Report.

There is much more that the Auditors could have learned if they had interviewed the fund managers. Each outside fund manager manages a portfolio for a number of clients in addition to the URS. For example, one outside fund manager manages a portfolio of small cap funds and has over 30 clients that are large, institutional clients like the URS. The fund managers have a team of analysts who engage in a complicated and lengthy process to select stocks for the portfolios. When a fund manager decides to purchase (or sell) a stock, this purchase is made across the board for all of the portfolio clients. Each client is allocated a proportional share of the stock. For example, a client that represents 10% of the portfolio would receive 10% of the stock. The fund managers are highly professional and manage money for sophisticated clients including other retirement systems and governmental entities. Obviously, a fund manager could not favor one client over others by giving that client advanced information concerning the fund manager's future trading plans. The Report's suggestion that professional fund managers might "provide investment tips in exchange for lax monitoring or additional investment fees" is ludicrous.

Each fund manager has sole and absolute control over investment decisions. They do not announce their trading strategies publicly nor do they disclose their trading strategies in advance to their clients. While fund managers will from time-to-time discuss particular stocks with a client, the discussions are of a general nature, not about what the fund manager intends to do. Clients have no input in the investment decision.

Clients do not learn of purchases or sales until after the trades are made.¹ Nor are they told how much of a particular stock the managers hope to eventually buy or sell, or at what price.

Had the Auditors interviewed the fund managers they would also have learned critical information about how the fund managers execute their trades. They would have learned that the fund managers operate so that their trades *do not* affect the market price of the stock. Since it is true that large trades could potentially impact the share price, they do not tell anyone that they intend to buy or sell a large amount of stock. They make their trades in small blocks and spread them out over time. They watch the market and if the prices rise or fall outside of their guidelines, they stop trading and reevaluate. The fact that they make an initial trade of shares is no guarantee that they won't change their mind the next day and stop trading that security. They are not committed to trade any number of shares.

Finally, the fund managers would have told the Auditors in no uncertain terms that nothing they discussed with the CIO could ever be considered "insider information." Since nothing about their discussion were "privileged" in any way, there would be nothing improper about the CIO using the general information about particular stocks to trade for his personal account.

Investing in Same Companies as the Fund

The Report contends that there are eleven instances in which the CIO invested in the same companies in which the URS fund manager purchased stock. The Report also states that some of these trades were "close to the same time" as the URS trades. In fact, there is no rule or policy that prohibits the CIO from investing in the same stocks that are held by the fund managers for the benefit of the URS. The Report notes that two state retirement systems employ blackout periods to restrict employees "from investing in specific securities within a certain time period during which the system is investing in those securities." Utah does not have such a restriction. Six other states require disclosure of personal investments, but apparently do not prohibit staff from investing in the same shares as the retirement funds. It appears from the Report that the majority of states do not have disclosure requirements. The problem is that the Report requests the Board to consider adopting a rule for the future prohibiting these personal investments, yet judges the CIO's conduct as if such a prohibition were already in place.

1

We are advised that any participant in the URS can request and obtain the URS funds' stock positions as of the close of business the previous day.

What the Report does not say is that the CIO made hundreds of trades for his personal account during the relevant time period. Of these hundreds of trades, the Legislative Auditor found only eleven occasions where the CIO happened to invest in the same stock near the same time as the fund managers. These eleven situations are addressed below.

Corillian

The Report shows that the fund manager began purchasing Conilian on October 10, 2001. The fact that the fund manager had been purchasing Corillian was publicly available. Almost two months after the fund manager began purchasing Corillian for URS, the CIO purchased 1,000 shares of Corillian on December 6. The Report indicates that the price of Corillian peaked at about \$5.24 on December 10 and then headed downward. The Report shows that the fund manager sold a small amount of Corillian on December 26, 2001 at \$4.50. Eight days later, the CIO sold his 1,000 shares at \$3.12. Nothing about this transaction suggests any impropriety on the part of the CIO.

Digimarc

The Report shows that the CIO purchased shares in Digimarc for his own account on September 20, 2001. At the time of the purchase, Digimarc was not owned by the URS. More importantly, the fund manager who later purchased the Digimarc shares on behalf of the URS *had not yet been hired* by the URS. This fund manager was hired by URS on October 10, 2001 and first purchased Digimarc stock for the URS account on October 11, 2001. Obviously, the CIO did not have material, non-public, proprietary information.

Electro Scientific

The Report shows that the fund manager purchased Electro Scientific shares from February 21, 2001 through March 12, 2001. Two weeks after the fund manager stopped purchasing, the CIO bought 200 shares in Electro Scientific. Two weeks later, the fund manager began selling the shares on April 9, 2001. Two weeks after that, the CIO sold his shares. The facts show that the CIO purchased *after* the fund manager purchased and sold *after* the fund manager sold. There is nothing about this transaction that even suggests advance knowledge of trading plans.

Grey Wolf

The Report points out the fact that the CIO purchased Grey Wolf on the same day and leaps to the speculative conclusion that the fund manager “may have provided the CIO with privileged information about the System’s future investment in [that company].” The CIO recalls some general discussion with the fund manager about this company (along with similar discussions regarding other companies). But the CIO and the fund

manager independently confirmed that the CIO was not given advance information that the fund manager was going to purchase this security for the URS portfolio.

The CIO would have learned of the purchase when the order was placed by the fund manager. As the Report shows, the CIO sold his position in Grey Wolf on November 17, 1999 even though the fund manager continued to buy the stock for two more months and did not sell the position until July 19, 2000 (eight months after the CIO sold).

Grey Wolf is an example of a small cap stock that traded high volumes. At that particular time Grey Wolf was trading almost one million shares a day. As can be seen from the Report, the fund manager continued to purchase the stock over the next two months and accumulated more than 1,000,000 shares without materially affecting the price.

The Report fails to identify any “privileged information.” It is common practice for all participants in this industry to discuss the investment merits of various securities based on their own personal beliefs. No non-public, proprietary information was ever exchanged between the fund managers and the CIO. The CIO’s discussions with the fund managers regarding different companies were always centered on the company fundamentals and never involved trading strategies. The CIO’s intent was to participate in fundamentally attractive companies.

Loral Space

The Report shows that the fund manager purchased Loral Space from, February 15, 2000 through September 22, 2000. The fund manager started selling on January 29 and 31, 2001 and then did nothing until August 16, 2001. During the interim, the CIO bought Loral space on March 13 and 22, 2001 and sold on June 11, 2001. Once again, these facts do not in any way suggest that the fund manager and the CIO were trading in concert. The CIO *bought* while the fund manager was *selling*. Clearly he was not acting on insider information.

Micron Technologies

The fund manager began purchasing Micron on March 2, 1999 and continued through December 10, 1999. The fund began selling the stock on March 1, 2000 at \$105.00 and sold on March 10 at \$108.00, March 13 at \$111.13 and \$115.69, and on March 14 at \$125.33. In this rising (yet volatile) market, the CIO purchased put options on March 14 at a strike price of \$120 and sold them the same day. There is nothing about these facts to support the allegation of insider trading. Indeed, the small number of shares traded by the fund manager relative to the average daily volume in excess of 13 million shares, demonstrates that the fund manager’s transactions could not have affected the stock price.

Orbital Sciences

The Report shows that the fund manager began purchasing Orbital Sciences on May 18, 2001 and stopped buying on September 20, 2001. After the fund manager stopped buying, the CIO bought Orbital on September 25, 2001 and sold it on February 11, 2002. The fund manager had no trades in this stock during the time period the CIO held the stock. The fund began selling the stock on February 26, 2001. Once again, there is nothing about these facts to support the speculative allegation of insider trading.

Paradigm

The Report shows that the fund manager purchased Paradigm from October 17, 2001 through December 31, 2001. Then, on January 23, 2002, the fund manager began selling the stock. Two months after the fund manager began *selling*, the CIO *bought* 2,000 shares. These facts show that the fund manager and the CIO were trading in opposite directions.

Petro Heat and PWR Co. Inc.

The Report shows that the fund manager began purchasing Petro Heat on January 2, 1997. Almost a month later, the CIO purchased Petro Heat shares. The fund continued to steadily purchase the stock through May 14, 1998 while the CIO sold his position on July 23, 1997 (ten months earlier). There was no insider information.

Fund Manager Purchased Shares in a Company in which the CIO Already Invested (Align Technologies)

The Report shows that the CIO purchased shares in Align Technology on September 27, 2001, and December 4, 2001. More than three months later, the fund manager began purchasing Align Technology. The CIO freely admitted that he had asked the fund manager what he thought about Align Technology. The Report jumps to the unwarranted conclusion that these discussions “may have” led the fund manager to purchase shares in Align Technology. The Report then concludes, without logic or support, “The CIO should avoid discussing his own investments with URS fund managers.”

If the Auditors had bothered to talk to the fund manager, they would have learned that the fund manager first considered Align Technology when it went public (prior to the time the manager was hired by the URS). At the time, the fund manager believed the stock to be too highly priced. In March 2002, the CIO asked the fund manager what he thought of Align Technology. The fund manager checked and found that the price had come down so he and his analysts began analyzing the company according to their complex decision-making formula and later made an independent decision to take a small position for all the clients in the managed fund.

The fund manager stated that the CIO did not suggest that he look at Align Technology, let alone suggest that he purchase the stock. In any event, it is not improper for a client to suggest that a fund manager take a look at a potential stock that may benefit the portfolio. Professional managers make independent decisions unaffected by client recommendations.

The Report states: "By purchasing shares in a small company a fund manager can put upward pressure on the price of the stock and provide a financial benefit to the CIO." But the trading history in the table immediately preceding the quote belies that conclusion. The price of Align Technology trended downward notwithstanding the purchases by the fund manager. Ultimately, the CIO lost money on the 2,000 shares of Align Technology.

Charles River Laboratories International Inc.

The URS received a direct distribution of 245,000 shares of Charles River Labs on November 8, 2001. The CIO made the decision to liquidate the stock since it appeared to be trading at a premium price. Shortly after the URS custody bank received the stock, the CIO authorized a URS broker to sell a block of the shares on November 14, 2001. The URS sold 50,000 shares at an average price of \$30.61 on that day. The next day the CIO placed another block of stock for sale with a different broker, never disclosing to the broker the full position or sales intentions of the URS. The broker was able, to sell the stock quickly and the market price was not affected. The broker then called the URS and asked if they had more Charles River Labs stock to sell since there was a demand in the market. Another block of stock was placed with the broker and he sold that order. The buying interest continued and the broker came back to the URS asking for additional blocks of stock until the remaining 195,396 shares were sold. The stock price held throughout the day. In fact the average price received for the shares sold on November 15 was \$30.75, which was \$.14 better than the preceding day's average price.

The Report is misleading in suggesting that the CIO "ordered the sale of 195,000 [shares on November 15, 2001]." The implication is that he ordered the sale of the total block of stock. The facts are clear that he "ordered" consecutive sales of smaller blocks of stock in response to the broker's requests to meet market demand.

The Report states that URS stock trades on November 15 constituted 65% of the average trading volume in the stock for the month of November. This is wholly misleading since November 15 was not an average day. On that particular day more than 800,000 shares traded and even the Report later acknowledges that URS was approximately 23% of the volume, a considerable difference. When interested buyers continued to appear on November 15 at or above the target sales price, it was wise to respond to their demands. It was only because the broker continued to come back to the URS with additional bids for stock that the remaining shares were all sold that day.

The URS was letting the market dictate the pace of the sale. Otherwise, the shares would have been sold in smaller blocks over a longer period of time.

The Report implies that the CIO purchased the puts for his own account at the same time he “ordered the sale of the 195,000 [shares].” Since the Auditors did not trace the trading history on November 15, they were not aware that the URS brokers had already sold more than 80% of the URS’ position before the CIO purchased his puts. The CIO placed his order for the puts after the broker had completed the sale of more than 80% of the Charles River Labs shares. The CIO believed that since the URS had essentially completed the sale of its shares he was free to trade for his own account. He knew that the broker’s sale of the remaining 18% in response to market demand would not have an adverse impact on the price. He was surprised by the strong buyer interest in the stock on November 15 and that the URS could liquidate the balance of its position in a single day. He believed, based on his personal evaluation of the stock, that it was overpriced, based on price to book, price to sales, and price earnings ratio, and should decline in value. He was wrong and lost almost \$1,500 on the transaction.

If a person had truly intended to profit at the Fund’s expense by engaging in “front running” as the Report suggests, he would have handled the transaction in a completely opposite manner from what the CIO did in this case. “Front running” means that such a hypothetical person would have purchased the puts before any URS shares were sold and then placed an order to sell the entire 245,000 shares as a single block. The sale of such a large block of stock might well have depressed the price. On the other hand, selling the shares in smaller blocks and only in response to market demand would not, and did not in this case, depress the market price. Indeed, the shares were sold by the CIO in a prudent fashion and in such a manner as to maximize the profit to the URS. Nothing the CIO did adversely affected the URS fund. It was only after the interests of the URS had been effectively taken care of that the CIO considered trading for his personal account. At the time he purchased his puts, he had no material, non-public, proprietary information that he could have used to his advantage.

Outside Employment as an Investment Advisor

It is entirely appropriate for the Auditors to raise the policy question of whether URS Board or staff may be involved in outside investor advisory services. This issue is moot, however, insofar as the CIO is concerned. He was briefly involved in an outside investment advisory firm for approximately 18 months in 1999 and 2000. URS policies did not prohibit this type of outside employment. The CIO appropriately disclosed this activity to URS management and the Auditors do not allege any improper conduct in the course of his employment as an outside investment advisor. He has no intention to seek such employment in the future.

Members of Audit Subcommittee
February 5, 2003
Page Eleven

In conclusion, the CIO is cooperating fully with the Board of Directors and its outside counsel and all other authorities in their review of these activities. He is confident that the evidence will show that he acted at all times in good faith and in the sincere belief that his conduct was in the best interests of the Utah Retirement Systems.

Sincerely,

Parsons Belie & Latimer

Francis M. Wikstrom

FMW/c1
cc: Legislative Auditor General
URS Board of Directors