

# Report Highlights

## Why DLA Performed This Audit

The audit was requested in response to allegations that the Alaska Mental Health Trust Authority (Authority) was not managing its assets and conducting its business in compliance with applicable laws.

## What DLA Recommends

1. The Authority board of trustees should stop investing in commercial real estate through the TLO, consult with the APFC on the treatment of commercial real estate investments acquired to date via TLO, and transfer the Trust Authority Development Account's cash principal balance to the APFC.
2. The Authority's board of trustees should fund future program-related investment (PRI) activities from the Trust income account and reconstitute the APFC with cash principal used on PRIs to date.
3. The Authority's board of trustees should work with the Authority and TLO management to revise the Asset Management Policy Statement and Resource Management Strategy to incorporate industry best practices and facilitate compliance with State investment laws.

Continued on Next Page

# A Performance Review of the Department of Revenue, Alaska Mental Health Trust Authority Asset Management and Other Select Issues

February 8, 2018

Audit Control Number 04-30090-18

## REPORT CONCLUSIONS

The audit concluded that the Authority's board of trustees violated State statutes and terms of the *State v. Weiss* settlement by diverting \$44.4 million in cash principal from the Alaska Permanent Fund Corporation (APFC). Alaska statutes clearly and unambiguously command that cash principal be managed and invested by the APFC. Despite the requirement, the Authority's board of trustees suspended transfers of cash principal to the APFC for almost 10 years. The board of trustees' actions appeared to be well intentioned, driven by a desire to maximize revenue for use by beneficiaries. However, the actions did not comply with law and were contrary to the roles and responsibilities outlined in the settlement.

Instead of transferring cash principal to the APFC for investment, \$39.5 of \$44.4 million was directly invested in seven commercial real estate properties (five located out-of-state) using the Trust Land Office (TLO) to facilitate the commercial real estate investment transactions and to manage the properties. Six of the seven properties were mortgaged and the proceeds were used, in part, for additional commercial real estate investments. The audit concluded that the TLO does not have the legal authority to manage commercial real estate investments. In accordance with the settlement and State law, investment is a function of the APFC. Furthermore, in approving these investments, the Authority's board inflated investment costs and reduced the asset diversification of the Trust portfolio as a whole. It is more appropriate and efficient to carry out commercial real estate investments via the APFC.

The remaining \$4.9 million in diverted cash principal was used for land development activities, including constructing and developing properties primarily used by beneficiary programs.

# Report Highlights (Continued)

4. The Authority's board of trustees and chief executive officer should design and implement written procedures to ensure trustees comply with the Alaska Executive Branch Ethics Act, the Open Meetings Act, and Authority's bylaws.

## REPORT CONCLUSIONS (Continued)

Because statutes require cash principal be managed and invested by the APFC, the only potential funding mechanism available in statutes for land development activities is Trust income. Development activities funded by cash principal included the mining exploration of Icy Cape. As of FY 17, the TLO had spent a total of \$1.6 million in cash principal for Icy Cape mine exploration, and the board of trustees approved another \$3 million for additional exploration activities.

In 2017, the Authority's management proposed draft legislation to its board of trustees to allow for the use of cash principal to purchase and develop real estate through the TLO and to ratify similar actions previously taken by the board. Public record provides no evidence that the Authority's management or board of trustees considered the proposed statutory changes in context of the settlement. The audit concluded that proposed changes to the Authority's statutes constitute a material change to statutes that present a substantial risk of provoking successful litigation to void the settlement agreement if the proposed changes become law.

As part of this audit, an investment firm was hired to evaluate the Authority's asset management policies for compliance with State investment law and industry best practices. The contractor concluded that the policies fall short in several areas including: lack of an entity-wide perspective that addresses all Trust assets; lack of guidance for the TLO's commercial real estate investment program; and failure to provide a rationale for using the TLO as a real estate investment manager at the time the investment decisions were made.

The audit concluded that the Authority's board of trustees did not comply with the Alaska Executive Branch Ethics Act, Open Meetings Act, and the Authority's bylaws when conducting its business. Evidence showed that multiple trustees were, at times, intentionally trying to avoid discussing board business in a public manner. Other times, evidence showed the board failed to recognize the importance of or need for adhering to State laws when conducting and noticing its meetings.

The review of Authority activities and relationships did not identify less than arm's length transactions. However, the audit found several employee and trustee professional and personal relationships that created an appearance of related parties or increased the risk of fraud or abuse. The audit found no indication that Authority financial statements materially misstated TLO-managed assets.

# ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

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April 3, 2018

Members of the Legislative Budget  
and Audit Committee:

In accordance with the provisions of Title 24, the attached report is submitted for your review.

ALASKA MENTAL HEALTH TRUST AUTHORITY  
ASSET MANAGEMENT AND OTHER SELECT ISSUES  
February 8, 2018

Audit Control Number  
04-30090-18

The audit responds to allegations that the Alaska Mental Health Trust Authority was not managing its assets and conducting its business in compliance with applicable laws.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology.

A handwritten signature in black ink, appearing to read "Kris Curtis".

Kris Curtis, CPA, CISA  
Legislative Auditor

## ABBREVIATIONS

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AAC	Alaska Administrative Code
ACN	Audit Control Number
AK	Alaska
AMHEA	Alaska Mental Health Enabling Act
AMPS	Asset Management Policy Statement
APFC	Alaska Permanent Fund Corporation
AS	Alaska Statute
Authority	Alaska Mental Health Trust Authority
Bld	Boulevard
CEO	Chief Executive Officer
CFA Institute	Chartered Financial Analyst Institute
CISA	Certified Information Systems Auditor
CPA	Certified Public Accountant
DLA	Division of Legislative Audit
DNR	Department of Natural Resources
DOR	Department of Revenue
ERISA	Employee Retirement Income Security Act
FY	Fiscal Year
HB	House Bill
IRR	Internal Rate of Return
LLC	Limited Liability Company
PRI	Program-Related Investments
RFP	Request for Proposal
RMS	Resource Management Strategy
RVK	RVK, Inc.
TADA	Trust Authority Development Account
TLO	Trust Land Office
Trust	Alaska Mental Health Trust
TX	Texas
UPIA	Alaska Uniform Prudent Investor Act
UPMIFA	Uniform Prudent Management of Institutional Funds Act
UT	Utah
WA	Washington

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# CONTENTS

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<b>Report Sections</b>	Organization and Function	1
	Background Information	3
	Report Conclusions	13
	Findings and Recommendations	53
	Objectives, Scope, and Methodology	61
<b>Agency Responses</b>	Office of the Governor	105
	Department of Revenue	107
	Department of Natural Resources	109
	Alaska Mental Health Trust Authority	113
	Legislative Auditor’s Additional Comments	119
<b>Appendices</b>	Appendices Summary	67
	Appendix A: Governing Principles For Board Operations And Trust Investments	69
	Appendix B: RVK Review of Alaska Mental Health Trust Authority Policies and Real Estate Transactions	75
<b>Exhibits</b>	Exhibit 1: Authority’s Mission	1
	Exhibit 2: Trust Management and Oversight Structure Created by the HB 201 Settlement	4
	Exhibit 3: Alaska Statutes Governing the Authority’s Cash Principal	5

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# CONTENTS

## (Continued)

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<b>Exhibits (Continued)</b>	Exhibit 4: Commercial Real Estate Investments as of June 30, 2017	11
	Exhibit 5: Cash Principal Expended Outside APFC FY 09 through FY 17	16
	Exhibit 6: Program-Related Real Estate as of June 30, 2017	21
	Exhibit 7: TLO-Managed Commercial Real Estate Investments as of June 30, 2017, Equity versus Mortgage	22
	Exhibit 8: Asset Management Policies: AMPS and RMS	27
	Exhibit 9: Aggressively Generating Income Not a Prudent Investment Rationale	31
	Exhibit 10: Growth of Authority Commercial Real Estate Investments FY 09 through FY 17	34
	Exhibit 11: Evolution of Commercial Real Estate Investment Size Parameters in RMS	36
	Exhibit 12: Legal Foundation for Conducting Board Business	41
	Exhibit 13: Less than Arm's Length Transactions	46
	Exhibit 14: TLO-Managed Assets as of June 30, 2017	50
	Exhibit 15: Icy Cape Block Map	51

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# ORGANIZATION AND FUNCTION

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## Alaska Mental Health Trust Authority

The Alaska Mental Health Trust Authority (Authority) was established in AS 47.30 as a public corporation of the State within the Department of Revenue (DOR). It serves as trustee for the Alaska Mental Health Trust (Trust) created by the federal Alaska Mental Health Enabling Act of 1956 (AMHEA). As trustee, the Authority has a fiduciary obligation to ensure that Trust assets are managed consistent with the AMHEA, and a duty to administer the Trust in the interest of beneficiaries, exercise a high degree of care, and use care and skill to preserve Trust property.<sup>1</sup> The Authority's mission is shown in Exhibit 1.

### Exhibit 1

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#### Authority's Mission

The Authority's mission is to administer the Trust as a perpetual trust and to ensure a comprehensive and integrated mental health program to improve the lives of beneficiaries.

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Source: Authority's website.

The Authority is governed by a seven-member board of trustees appointed by the governor and confirmed by the legislature. In accordance with AS 47.30.016, members are appointed based on their ability in financial management and investment, in land management, or in services for the beneficiaries of the trust. Trustees receive an honorarium of \$200 for each day or any part of a day spent at a board meeting, subcommittee meeting, or as representative of the board. The duties of the board include preserving and protecting the Trust corpus.<sup>2</sup>

The board selects and employs a chief executive officer who is responsible for management of the Authority's operations. The chief executive officer hires employees to administer the Authority's programs. The Authority's FY 18 budget totaled \$4.4 million,

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<sup>1</sup>Alaska Statute 37.14.007.

<sup>2</sup>Alaska Statute 47.30.036.

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including \$2.7 million for personal services which funded 17 full-time positions.

## **Department of Natural Resources**

In accordance with AS 37.14.009, the Authority contracts with the Department of Natural Resources (DNR) through a memorandum of understanding to manage the land assets of the Trust. DNR's mission is to develop, conserve, and maximize the use of Alaska's natural resources consistent with the public interest. The Trust Land Office (TLO) is a unit within DNR created to contract exclusively with the Authority to manage and develop Trust land. The TLO's FY 18 budget totaled \$4.2 million, including \$2.8 million for personal services which funded 18 full-time positions and one non-permanent position.

## **Alaska Permanent Fund Corporation**

In accordance with AS 37.14.009, the Authority contracts with the Alaska Permanent Fund Corporation (APFC) through a memorandum of agreement to manage the mental health trust fund. The mental health trust fund is a separate fund of the Authority that consists of Trust cash principal assets. The APFC is a State-owned corporation within DOR that manages the assets of the Alaska Permanent Fund and other funds designated by law, including the mental health trust fund.

A six-member, governor-appointed board of trustees oversees the APFC. One seat is statutorily assigned to the DOR commissioner. The governor selects one additional cabinet member to sit on the board. Four public members — who are required to have recognized competence and wide experience in finance, investments, or other business management-related fields — fill the remaining seats, which have staggered four-year terms. The APFC board appoints an executive director who manages approximately 50 staff members.

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# BACKGROUND INFORMATION

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## Legal Framework

In 1956, the federal Alaska Mental Health Enabling Act (AMHEA) was passed by Congress to transfer responsibility for providing mental health services from the federal government to the Territory of Alaska by creating the Alaska Mental Health Trust (Trust). The AMHEA provided broad discretion to Alaska for land management:

*All lands granted to the Territory of Alaska under this section, together with the income therefrom and the proceeds from any dispositions thereof, shall be administered by the Territory of Alaska as a public trust. [...] Such lands, together with any property acquired in exchange therefor or acquired out of the income or proceeds therefrom, may be sold, leased, mortgaged, exchanged, or otherwise disposed of in such manner **as the Legislature of Alaska may provide**, in order to obtain funds or other property to be invested, expended, or used by the Territory of Alaska. [Emphasis added]<sup>3</sup>*

Per the AMHEA, management of the Trust is subject to Alaska statutes promulgated by the legislature.

The State of Alaska's management of the Trust was challenged in a class action suit, *State v. Weiss*, in 1982, alleging that the State violated terms of the Trust. In a 1985 decision, the Alaska Supreme Court affirmed that the Alaska Legislature breached the trust by removing federal grant lands from the Trust.

After lengthy negotiations and two unsuccessful settlement attempts, the parties finally reached a settlement in June 1994. As a part of settling the lawsuit, the Alaska Legislature passed House Bill (HB) 201 to change Trust statutes. This bill was incorporated into the agreement and became an integral part of the settlement. The *Memorandum Decision and Order Granting Final Approval to the HB 201 Settlement* and the *Dismissal Order*, written by Superior Court Judge Mary E. Green in December 1994, finalized the settlement process.

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<sup>3</sup>AMHEA Section 202(e).

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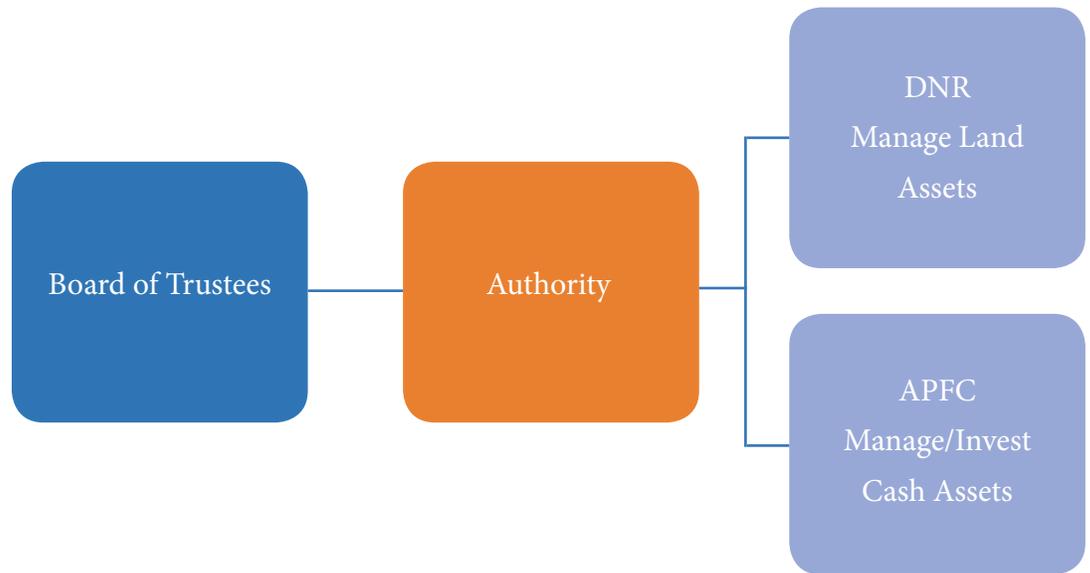
Several parties were not satisfied with the result and challenged the HB 201 settlement in a 1997 lawsuit. The Alaska Supreme Court denied the petition, reciting legislative efforts to settle litigation and passage of HB 201.

The HB 201 settlement reconstructed the Trust with 500,000 acres of original Trust land and 500,000 acres of replacement land, plus \$200 million in cash to be retained perpetually. It also created the Alaska Mental Health Trust Authority (Authority) to serve as trustee of the Trust assets and created the asset management and oversight structure described in Exhibit 2. This structure, as set up in statute, was incorporated as a condition of the settlement.

**Exhibit 2**

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**Trust Management and Oversight Structure  
Created by the HB 201 Settlement**



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Source: Alaska Statutes and settlement documents.

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The Authority, governed by a board of trustees, was given a fiduciary obligation to ensure that the Trust assets are managed consistent with the requirements of the AMHEA. Statutes require Trust cash principal to be managed by the Alaska Permanent Fund Corporation (APFC) (see Exhibit 3).

### **Exhibit 3**

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#### **Alaska Statutes Governing the Authority’s Cash Principal**

**AS 37.14.009** requires the Authority to “contract with Alaska Permanent Fund Corporation for management of the mental health trust fund.”

**AS 37.13.300** requires the Alaska Permanent Fund Corporation to manage the mental health trust fund.

**AS 37.14.031** states, “The mental health trust fund [...] consists of the cash assets of the principal of the trust, and includes (1) money appropriated to the fund; (2) the proceeds of sale or other disposals of mental health trust land, and the fees, charges, income earned, royalty proceeds, and other money received from the management of mental health trust land attributable to principal; and (3) gifts, bequests, and contributions from other sources.”

**AS 37.14.033** states, “The mental health trust fund shall be managed by the Alaska Permanent Fund Corporation.”

**AS 37.14.035** states, “The cash principal of the mental health trust fund shall be retained perpetually in the fund for investment by the Alaska Permanent Fund Corporation.”

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Source: Alaska Statutes.

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Trust land assets must be managed by the Department of Natural Resources (DNR)<sup>4</sup> in accordance with AS 38.05.801, which states:

*(a) Mental health trust land shall be managed [by DNR] consistent with the trust principles imposed on the state by the Alaska Mental Health Enabling Act, P.L. 84-830, 70 Stat. 709 (1956).*

*(b) Subject to (a) of this section, the department (1) shall manage mental health trust land under those provisions of law applicable to other state land.*

## Trust Cash Assets

The Trust cash assets are comprised of principal and income:

- Trust Cash Principal

The cash principal includes the initial appropriation of \$200 million made as a part of the settlement and the proceeds received from management of the Trust land attributable to principal.<sup>5</sup> The APFC manages the mental health trust fund which includes the majority of the Trust cash principal from the original endowment and a portion of the Trust Land Office's (TLO)<sup>6</sup> land management proceeds transferred to the APFC for investment.

Assets invested by the APFC have been comingled with the assets of the Alaska Permanent Fund for investment purposes, with the Trust owning unit shares rather than direct asset interest. The APFC maintains a diverse investment portfolio which includes debt securities, preferred and common stocks, private equity, and real estate. The APFC's real estate investments are comprised of directly owned real estate, real estate investment trusts, a multi-family real estate operating company, and other entities in which the assets consist primarily of real property.

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<sup>4</sup>Alaska Statute 37.14.009 requires the Authority to contract with DNR to manage the land assets of the trust.

<sup>5</sup>Alaska Statute 37.14.031.

<sup>6</sup>The TLO is a unit within DNR created to contract exclusively with the Authority to manage and develop Trust land.

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Cash proceeds derived from the TLO's land management transactions attributed to principal are deposited in the Trust Authority Development Account (TADA), formerly referred to as Trust Land Development Account.<sup>7</sup> The TADA was designed as a holding account to facilitate quarterly transfers to the mental health trust fund managed by the APFC. Starting in 2009, the board of trustees suspended cash transfers from the TADA to the APFC. The Department of Revenue's (DOR) Division of Treasury manages cash balances of the TADA.

- Trust Income

Trust income is comprised of the "fees, charges, income earned on assets, and other money received by the trust that is not attributable to the principal."<sup>8</sup> Trust income is generated by the APFC from the cash principal investments and by TLO from its land management activities. Income is primarily used to award grants and to cover the Authority's operating expenditures.<sup>9</sup>

Trust income is deposited into the Trust settlement income account, which is managed and invested by DOR's Division of Treasury. Investing is performed by internal investment officers or contracted investment managers. The division invests income in the same manner as other State funds.

The Authority also maintains income reserves to provide for spending if the asset portfolio does not achieve its earning objectives. The management of the reserve is split between DOR's Division of Treasury and the APFC. The Authority's policy is to maintain the reserve at 400 percent of the prior year spending rate.

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<sup>7</sup>The Authority's management stated that some funds held in the TADA are not cash proceeds, as they were used for exchanging one land asset for another. However, the audit's review of statutes concludes that funds from land transactions attributable to principal are cash proceeds that should be managed by the APFC.

<sup>8</sup>Alaska Statute 37.14.036.

<sup>9</sup>Alaska Statute 37.14.041.

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## Trust Land Assets

Trust land assets are managed by DNR's TLO. TLO land management activities include land, minerals and energy, forest resources, and real estate. Real estate activities are comprised of the following:

- *Real estate development.* For existing surface estates, the TLO developed Trust vacant land in areas such as the "U-Med" district in Anchorage, the "Subport" in Juneau, and the Yosemite Drive Upgrade Project in Eagle River.
- *Program-related real estate.*<sup>10</sup> Through construction and intergovernmental transfers, the Trust acquired six buildings located in Anchorage, Fairbanks, and Juneau.<sup>11</sup> These buildings were mainly used for the purpose of serving Trust beneficiaries.
- *Commercial real estate investments.* Between FY 12 and FY 17, the Authority purchased seven commercial real estate properties as investments through the TLO; five of the seven are located outside of Alaska.<sup>12</sup>

## History of Real Estate Activities through TLO

As a part of the 1994 HB 201 settlement, DNR's TLO was given the responsibility to manage Trust lands for multiple use and for long-term sustained yield of products from the land.<sup>13</sup> According to the Authority's management, the board of trustees determined early on that funding for the land management activities was not clearly provided for in statutes. Trustees decided that all capitalizable land management costs should be funded from Trust principal, and costs that did not increase the value of land should be covered by Trust income.

The underlying rationale for using principal was that certain costs improve the assets' life-span or increase value, and, thus, principal funds used for capitalized costs were being reinvested into the Trust's existing land assets. Examples of capitalized land management expenses include adding a road to improve accessibility

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<sup>10</sup> Also referred to by the Authority and the TLO as "program-related investment."

<sup>11</sup> These buildings are reported in the Authority's financial statements as capital assets and valued at historical cost.

<sup>12</sup> The commercial real estate investments are reported in the Authority's financial statements as investments and valued at fair market value.

<sup>13</sup> Alaska Statute 38.05.801(c)(3) and AS 38.05.801(c)(4).

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and constructing a utility extension as a part of a residential lot subdivision. According to TLO management, routine operating and maintenance costs were funded by Trust income. Since the Authority could not withdraw principal funds from the APFC, the capitalizable land management costs were paid from principal cash maintained in the TADA.

The original land asset portfolio managed by the TLO was comprised of surface estates, subsurface estates, and hydrocarbon (oil and gas) interest provided to the Trust as a part of settlement. However, the Authority started expanding its asset holdings and, in 2002, purchased through the TLO three buildings comprised of two older residential houses and a residential apartment building converted into offices. The properties were purchased for the purpose of enhancing the value of adjacent Trust lands and were rehabilitated and rented; the TLO occupied the office building from 2003 through 2011.<sup>14</sup>

In 2007, the board of trustees approved expending \$800,000 in principal funds to construct the Fairbanks Detox Center building. According to the Authority's records, total funding for the construction of the building was approximately \$3.37 million, with additional funds coming from the Denali Commission, State of Alaska Department of Health and Social Services, Rasmuson Foundation, Fairbanks Hospital Foundation, and local sources.

In 2009, the global financial crisis caused the largest negative return in APFC's history. A return of minus 18 percent was allocated to Trust cash assets managed by the APFC, resulting in a loss of \$75.8 million. The decrease in financial markets coincided with the decline in commodity prices that adversely affected the revenues generated by the TLO from its land transactions.

Driven by concerns over revenues, the Authority's board of trustees started looking for other sources of stable income. Trustees viewed commercial real estate investments as an opportunity to generate

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<sup>14</sup>All three properties were demolished in 2013 due to poor condition and the anticipated increase in revenues from the cleared land.

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consistent rental income. Trustees also believed that, due to the financial crisis, real estate was undervalued and good investment opportunities were available. In FY 11, the board of trustees decided to pursue alternative sources of income by beginning “a long-term strategy to mitigate risk of the trust holdings through geographical and property type diversification.”<sup>15</sup> As a result, between FY 12 and FY 17, the Authority used principal funds from the TADA to purchase through the TLO seven commercial real estate investment properties; five of seven are located out-of-state. As shown in Exhibit 4, the Authority owned \$98 million in commercial real estate investments acquired and managed through the TLO as of June 30, 2017.

The first commercial real estate investment was the Cordova building located in Anchorage. It was purchased in FY 12 with cash principal and houses the TLO office, with the remainder being multi-tenant office space. The next acquisition was the Commercial Drive building in Anchorage purchased in late FY 12 and leased to Cummins, a multinational corporation. Commercial Drive was the first property that was mortgaged and owned by the Trust through a Limited Liability Company (LLC).<sup>16</sup> All subsequent properties were mortgaged and acquired through LLCs to increase the return on investment and reduce liability.

In May 2013, the Authority purchased through TLO the first out-of-state property: a facility in Ogden, Utah, which was long-term leased to the Internal Revenue Service. This purchase was followed by the acquisition of an office building in Tumwater, Washington, leased to two Washington State government agencies. The last three commercial real estate investments, acquired in 2014, 2015, and 2016, are located in Texas and are multi-tenant office complexes (Promontory Point, Austin; North Park, San Antonio; and, Amber Oaks, Austin).

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<sup>15</sup>Source: 2014 TLO Annual Report.

<sup>16</sup>The use of LLCs is not addressed in AMHEA, settlement documents, or statutes, but it is a common business practice applied by investors to shield trust funds from liability.

**Exhibit 4**

<b>Commercial Real Estate Investments as of June 30, 2017</b>						
<b>Building Name</b>	<b>Address</b>	<b>Acquisition Date</b>	<b>Ownership (Trust or LLC Name)</b>	<b>Fair Market Value</b>	<b>Mortgage Balance</b>	<b>Equity</b>
Cordova	2600 Cordova Street Anchorage, AK 99503	7/1/2011	Trust	\$5,150,000	\$ 0	\$5,150,000
Cummins	2618 Commercial Drive Anchorage, AK 99501	4/6/2012	2618 Commercial Drive Investment Group, LLC	2,700,000	1,177,477	1,522,523
IRS	1973 North Rulon White Blvd Ogden, UT 84201	5/14/2013	1973 North Rulon White, LLC	13,300,000	7,353,283	5,946,717
Israel	1111 Israel Road SW Tumwater, WA 98504	1/7/2014	1111 Israel Road, LLC	17,400,000	8,484,550	8,915,450
Promontory Point	2420 & 2500 Ridgepoint Drive Austin, TX 78754	10/1/2014	TLO TX1 Investments, LLC	16,200,000	9,932,693	6,267,307
North Park	17319 San Pedro Ave San Antonio, TX 78232	9/11/2015	TLO TX2 Investments, LLC	16,839,914	7,338,441	9,501,473
Amber Oaks	9601 Amberglen Boulevard Austin, TX 78729	8/2/2016	TLO TX3 Investments, LLC	26,613,750	13,089,832	13,523,918
<b>Total</b>				<b>\$98,203,664</b>	<b>\$47,376,276</b>	<b>\$50,827,388</b>

Source: TLO records.

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# REPORT CONCLUSIONS

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This audit was requested in response to concerns over management of Alaska Mental Health Trust (Trust) assets and conduct of Trust business. Specific audit objectives are described in the Objectives, Scope, and Methodology section of the report and include, in part:

- Determining whether Trust assets were managed in compliance with State law and in compliance with the federal Alaska Mental Health Enabling Act (AMHEA) requirements;
- Determining whether the Alaska Mental Health Trust Authority (Authority) commercial real estate investment activities conducted via the Trust Land Office (TLO) duplicate those carried out by the Alaska Permanent Fund Corporation (APFC) and whether such activities should be more appropriately or efficiently carried out by the APFC;
- Evaluating Authority asset management policies for compliance with statutes;
- Evaluating whether the conduct of Authority board and committee meetings complied with State law and Authority bylaws;
- Identifying Trust transactions that could be considered less than arm's length; and
- Reviewing the Authority's financial accounting and reporting of Trust assets.

The audit concluded that the Authority's board of trustees violated State statutes and terms of the *State v. Weiss* settlement by diverting \$44.4 million in cash principal from the APFC. Alaska statutes clearly and unambiguously command that cash principal be managed and invested by the APFC. Despite the requirement, the Authority's board of trustees suspended transfers of cash principal to the APFC for almost 10 years. The board of trustees' actions appeared to be well intentioned, driven by a desire to maximize revenue for use by beneficiaries. However, the actions did not comply with law and were contrary to the roles and responsibilities outlined in the settlement.

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Instead of transferring cash principal to the APFC for investment, \$39.5 of \$44.4 million was directly invested in seven commercial real estate properties (five located out-of-state) using the TLO to facilitate the commercial real estate investment transactions and to manage the properties. Six of the seven properties were mortgaged and the proceeds were used, in part, for additional commercial real estate investments. The audit concluded that the TLO does not have the legal authority to manage commercial real estate investments. In accordance with the settlement and State law, investment is a function of the APFC. Furthermore, in approving these investments, the Authority's board inflated investment costs and reduced the asset diversification of the Trust portfolio as a whole. It is more appropriate and efficient to carry out commercial real estate investments via the APFC.

The remaining \$4.9 million in diverted cash principal was used for land development activities, including constructing and developing properties primarily used by beneficiary programs. Because statutes require cash principal be managed and invested by the APFC, the only potential funding mechanism available in statutes for land development activities is Trust income. Development activities funded by cash principal included the mining exploration of Icy Cape. As of FY 17, the TLO had spent a total of \$1.6 million in cash principal for Icy Cape mine exploration, and the board of trustees approved another \$3 million for additional exploration activities.

In 2017, the Authority's management proposed draft legislation to its board of trustees to allow for the use of cash principal to purchase and develop real estate through the TLO and to ratify similar actions previously taken by the board. Public record provides no evidence that the Authority's management or board of trustees considered the proposed statutory changes in context of the settlement. The audit concluded that proposed changes to the Authority's statutes constitute a material change to statutes that present a substantial risk of provoking successful litigation to void the settlement agreement if the proposed changes become law.

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The audit concluded that the Authority's board of trustees did not comply with the Alaska Executive Branch Ethics Act, Open Meetings Act, and the Authority's bylaws when conducting its business. Evidence showed that multiple trustees were, at times, intentionally trying to avoid discussing board business in a public manner. Other times, evidence showed the board failed to recognize the importance of or need for adhering to the State laws when conducting and noticing its meetings.

The review of Authority activities and relationships did not identify less than arm's length transactions. However, the audit found several employee and trustee professional and personal relationships that created an appearance of related parties or increased the risk of fraud or abuse. The audit found no indication that Authority financial statements materially misstated TLO-managed assets.

Detailed conclusions are presented below.

## **The Authority's diversion of cash principal from the APFC violated State statutes and terms of the settlement.**

The Authority deviated from State statutes and terms of the settlement<sup>17</sup> by diverting cash principal from the APFC. TLO's land-related transactions generate cash; a portion of the cash attributable to principal is deposited in the Trust Authority Development Account (TADA).<sup>18</sup> As discussed in the Background Information

<sup>17</sup>The Memorandum Decision and Order Granting Final Approval to the HB 201 Settlement ordered approval of the settlement *as embodied in law* (the law being the statutory framework). Thus, the statutes are incorporated into the settlement.

<sup>18</sup>In accordance with 20 AAC 40.610: 100 percent of land sale revenues; 100 percent of royalties on coal, oil, gas, materials, and minerals; 100 percent of revenues from perpetual easements; and 85 percent of revenues from timber sales are allocated to principal.

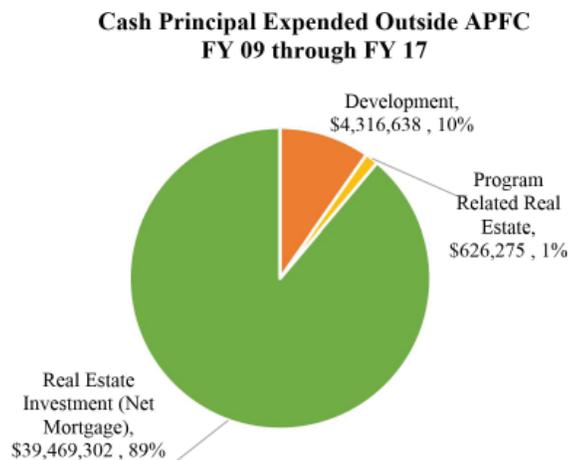
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section of this report, statutes clearly and unambiguously command that cash principal be managed and invested by the APFC. The Authority’s board of trustees violated the statutes by suspending transfers of cash principal from the TADA to the APFC for the period of November 2008 through December 2017.<sup>19</sup>

Instead of transferring cash principal to the APFC, the Authority’s board of trustees approved the use of principal to purchase commercial real estate investments and develop Trust land. As shown in Exhibit 5, from FY 09 through FY 17, \$44.4 million of cash principal from land-related transactions was diverted from the APFC and expended. Of the diverted principal funds, 89 percent was expended on commercial real estate investments, 10 percent on development activities, and one percent on the program-related real estate. Additionally, as of the end of FY 17, the TADA had a cash principal balance of \$19.6 million that had not been transferred to the APFC.

### Exhibit 5

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Source: State accounting records.

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<sup>19</sup>The board authorized a \$5 million transfer to APFC during the November 16, 2017, board meeting. The transfer was completed on January 8, 2018.

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In a letter to the legislative auditor dated September 11, 2017, the Authority's board of trustees justified the diversion of cash principal for commercial real estate investments by stating that:

*some land-based principal revenue may be **temporarily** used for management of land assets, to preserve or enhance the land assets of the Trust. Cash assets ultimately generated by the disposal or depletion of land assets must be reinvested with and managed by the Alaska Permanent Fund Corporation. [Emphasis added]*

The audit concludes that “temporary” use cannot reasonably extend to the purchase of commercial real estate investments or to the development of capital projects. A prudent investor would consider commercial real estate investments and capital development a long-term use of assets.

The Authority's board of trustees also stated in the September 11, 2017, letter that, “If funds are reinvested in non-cash land-based assets consistent with AS 37.14.009(a)(2) they may remain land assets managed by TLO.” This implies that the act of investment itself in non-cash land based assets provides the TLO with the legal authority for managing the investment. This is not a reasonable interpretation of statutes, which clearly mandate cash principal be managed and invested by the APFC.

The audit recommends that the Authority's board of trustees discontinue investing in commercial real estate through the TLO, consult with the APFC on the treatment of commercial real estate investments acquired to date via TLO, and transfer the TADA cash balance to the APFC. (Recommendation 1)

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**The TLO does not have authority to manage commercial real estate investments.**

As of the end of FY 17, the Trust owned seven commercial real estate investments managed by the Department of Natural Resources' (DNR) TLO, located in Alaska, Utah, Washington, and Texas. The audit concluded that while the TLO is authorized to manage the in-state land allotted to the Trust as a part of the settlement, the TLO is not authorized to manage a national commercial real estate investment program.

The settlement intentionally separated the Authority's, TLO's, and APFC's responsibilities based on their areas of expertise. According to the *Memorandum Decision and Order Granting Final Approval to the HB 201 Settlement*:

*The advantage of [the] split in responsibilities is that each of the three entities can concentrate on their area of expertise. The Alaska Permanent Fund Corporation has demonstrated its ability to manage a similar monetary fund satisfactorily. [...] DNR [...] has personnel with much experience and technical expertise in managing large tracts of land in Alaska. This leaves the Trust Authority to concentrate on coordinating with the four legislatively-established groups representing the major beneficiary groups to plan services to meet the needs of the beneficiaries and to budget the money to fund services.*

The responsibility for investing and managing cash principal was assigned to the APFC as part of the settlement, while TLO responsibilities were intentionally limited to managing tracts of land. "Land" is defined in DNR statutes as all land or resources belonging to or acquired by the State.<sup>20</sup> The review of meeting minutes documenting deliberations surrounding HB 201<sup>21</sup> shows that the Trust land was to include in-state surface estates, subsurface estates, and hydrocarbon (oil and gas) interest (i.e. the land acquired by the Trust as a result of the settlement).

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<sup>20</sup>Alaska Statute 38.05.965(24).

<sup>21</sup>The Alaska Legislature passed HB 201 as a part of settling the lawsuit to change the Trust statutes. HB 201 was incorporated into the settlement agreement.

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**Cash principal was inappropriately used by the Authority to fund land development activities.**

The Authority’s board of trustees redefined TLO’s land management responsibilities to include commercial real estate investing, and refers in its policy documents to TLO-managed commercial real estate investments and Trust land as “Trust non-cash assets.” However, there is no mention of “non-cash” assets in the statutes or the settlement. On the contrary, the settlement segregated the responsibilities of the Authority, TLO, and APFC according to each entity’s expertise. Investing responsibilities were specifically assigned to the APFC.

The audit recommends that the Authority’s board of trustees discontinue investing in commercial real estate through the TLO, consult with the APFC on the treatment of commercial real estate investments acquired to date via TLO, and transfer the TADA cash balance to the APFC. (Recommendation 1)

As shown in Exhibit 5 on page 16, from FY 09 through FY 17, the Authority expended \$4.3 million in cash principal on land development. According to Authority and TLO management, Trust cash principal was used for land development activities to allow TLO to meet its responsibility for developing and maintaining existing Trust land assets.

The audit confirmed TLO has a responsibility to develop and maintain Trust land assets. Alaska Statute 38.05.801(c) specifically requires TLO to maintain the Trust land base, manage for long-term sustained yield of products from the land, and manage for multiple use.

Although there is a responsibility to develop and maintain land, the settlement does not clearly identify the funding mechanism for such purposes. The only funding mechanism appears to be found in AS 37.14.041, which addresses the appropriate uses of Trust income and holds that income can be used as a “reimbursement to [...] the Department of Natural Resources for the cost of managing mental health trust land.”

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**Program-related real estate should have been funded from trust income.**

The Authority’s board of trustees narrowly interpreted AS 37.14.041 as only allowing the income to be used for TLO’s overhead costs, thereby concluding that income could not be used to fund TLO’s land development activities. To meet its responsibilities, the board of trustees chose to fund land development activities using cash principal generated from land management transactions, despite the clear statutory requirement that principal be managed by the APFC. As concluded earlier, the use of cash principal for development activities violated statutes and, as such, was contrary to the terms of the settlement.

Program-related real estate, also referred to by the Authority and the TLO as program-related investments (PRI), are trust buildings acquired through intergovernmental transfers or constructed on trust land.<sup>22</sup> Despite the use of the word “investments,” PRI buildings do not constitute investments and are reported on the financial statements as capital assets. The audit concluded that use of cash principal to develop PRI buildings was not in accordance with statutes, which require cash principal be managed by the APFC. Thus, the Authority should have funded PRI activities from Trust income.

As shown in Exhibit 6 on page 21, as of June 30, 2017, the Authority owned six buildings. The Resource Management Strategy<sup>23</sup> describes PRIs in the context of serving beneficiaries, and the buildings owned by the Authority were primarily leased to beneficiary-serving organizations. However, DNR management reported that these buildings could be used for other purposes in the future.

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<sup>22</sup>Most of these buildings are located on Trust land received as a part of the settlement.

<sup>23</sup>The Resource Management Strategy establishes goals for managing Trust land assets by the TLO.

## Exhibit 6

Program-Related Real Estate as of June 30, 2017			
Building Name	Address	Acquisition Date	Historical Value
Assets	2330 Nichols Street Anchorage, AK 99508	11/14/2014 (building)	\$3,365,101
Denardo	1300 Moore Street Fairbanks, AK 99709	10/16/2014 (building)	852,862
Fahrenkamp	1423 Peger Road Fairbanks, AK 99709	10/16/2014 (building)	1,374,056
TAB	3745 Community Park Loop Anchorage, AK 99508	12/5/96 (land) 10/8/04 (building)	1,304,157
Detox Center	650 Yonker Court Fairbanks, AK 99709	4/15/2009 (building)	2,574,455
Whittier Street	450 Whittier Street Juneau, AK 99801	6/24/2010 (land) 5/1/2017 (building)	500,000
<b>Total</b>			<b>\$9,970,631</b>

Source: TLO records.

The Authority expended at least \$1.8 million in principal funds on constructing and developing the PRI buildings from FY 07 through FY 17;<sup>24</sup> however, these activities should have been funded by Trust income.<sup>25</sup> The use of Trust income to construct and develop the PRI buildings leased to the beneficiary-serving organizations is authorized by AS 37.14.041(a)(1), which states:

*Money in the mental health trust settlement income account may [...] be used for [...] the awarding of grants and contracts in fulfillment of the authority's purpose to ensure an integrated comprehensive mental health program for the state.*

<sup>24</sup>The amount is comprised of \$600,000 in TAB remodel costs, \$800,000 for the Detox Center, \$220,000 for demolition of the 7th and L Street buildings in Anchorage, and \$145,000 in maintenance expenditures. The total amount is different from Exhibit 5, primarily because that exhibit reports the expenditures for the shorter timeframe – FY 09 through FY 17.

<sup>25</sup>The PRI activities could also be funded by third party grants and other external sources.

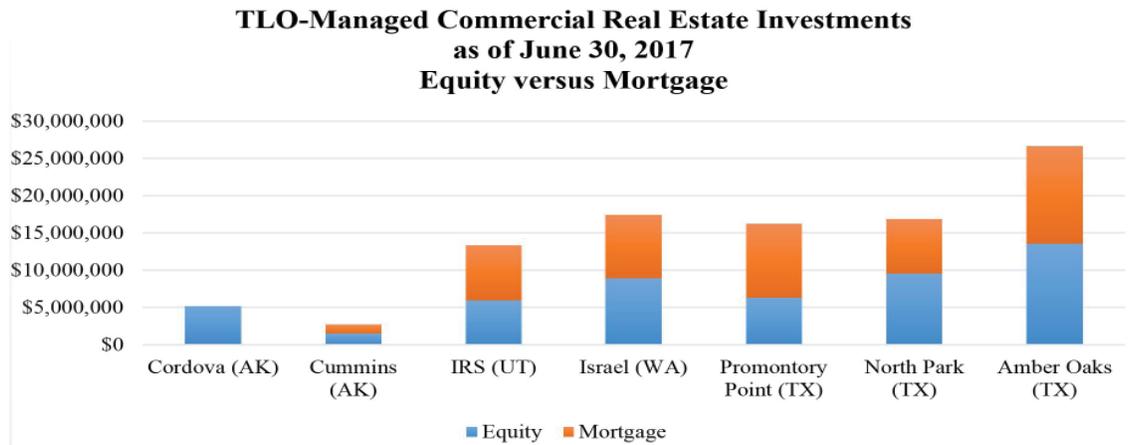
**Use of mortgage proceeds was not consistent with State statutes.**

The audit recommends the Authority’s board of trustees fund future PRI building activities from the Trust income account, and reconstitute the APFC for the cash principal already used for this purpose. (Recommendation 2)

Six of seven commercial real estate investments acquired by the Authority through the TLO were mortgaged. The audit concluded that Trust assets were mortgaged in accordance with applicable laws; however, the use of mortgage proceeds<sup>26</sup> did not comply with statute.

As of FY 17, the total fair market value of the commercial real estate investments managed by the TLO was \$98 million; of this amount, 48 percent, or \$47 million, was mortgaged. Exhibit 7 shows equity and mortgage by property.

**Exhibit 7**



Source: TLO records.

Four properties (Cummins, IRS, Israel, and Promontory Point) were purchased for cash and subsequently mortgaged.<sup>27</sup> Mortgage proceeds received from lenders, totaling \$30 million, were used, in part, for other commercial real estate investments.

<sup>26</sup>Mortgage proceeds are net amounts disbursed by a lender to a borrower, under the terms of a loan agreement.

<sup>27</sup>The last two properties, North Park and Amber Oaks, were mortgaged at the time of acquisition.

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Mortgaging assets complies with the AMHEA and State statutes. In accordance with the AMHEA, the Trust’s “lands, together with any property acquired in exchange therefor or acquired out of the income or proceeds therefrom, may be [...] mortgaged.”<sup>28</sup> The *State v. Weiss* settlement and resulting statutes do not explicitly address mortgaging; however, AS 38.05.801 requires Trust land to be managed consistent with the trust principles imposed on the State by the AMHEA. Since the AMHEA allows for the mortgaging of trust assets, by extension, State law also allows for mortgaging.

Furthermore, because the Alaska Mental Health Trust is a “trust,” the provisions of general trust law (AS 13.06 – AS 13.36) apply to its operations. Among the provisions is AS 13.36.109(6), which permits the mortgage of trust property, and AS 13.36.109(18), which includes the power “to borrow money for a trust purpose to be repaid from Trust property.”

While mortgaging of Trust assets is allowed, mortgage proceeds were not used in accordance with State statutes. As described earlier in Report Conclusions, statutes require cash principal to be managed by the APFC. Alaska Statute 37.14.031 clarifies that cash principal includes “the proceeds of sale or other disposals of mental health trust land, and the fees, charges, income earned, royalty proceeds, and other money received from the management of mental health trust land attributable to principal.” Mortgage proceeds fall under this definition and are considered cash principal that is required to be managed by the APFC.

**Proposed changes to the Authority’s statutes, if enacted, present substantial risk of provoking successful litigation to nullify the changes.**

At the March 24, 2017, board meeting, the Authority’s board of trustees considered draft legislation that included a substantial revision of the Authority’s authorizing statutes. Based on the verbatim minutes transcript, the proposed legislation was narrowly developed to answer questions in the request for this audit.<sup>29</sup> At the heart of the draft bill was the idea that trustees would have discretion to manage land principal proceeds outside of the APFC.

<sup>28</sup>AMHEA Section 202(e).

<sup>29</sup>Pages 94 and 96 of March 24, 2017, verbatim minutes.

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The draft bill was extensive and ended with a specific provision to ratify the Authority’s long standing practice of diverting Trust land sale proceeds from the APFC.

As part of this audit, an attorney was hired to help review the Authority’s management of Trust assets. The attorney concluded that material changes to the Authority’s statutes presents a substantial risk of provoking successful litigation to nullify the changes.

The discussion of the proposed legislation, as documented in the meeting minutes, failed to consider the effect of the *State v. Weiss* settlement on the future statutory changes. However, changes to the statutes must consider the impact on the settlement because the *Memorandum Decision and Order Granting Final Approval to the HB 201<sup>30</sup> Settlement* ordered approval of the settlement as embodied in law (the law being the statutory framework outlined in HB 201).

The Alaska Supreme Court dealt definitively with the possibility of a future legislature passing legislation affecting the Trust in *Weiss v. State* (Alaska 1997) at pages 396-397:

*Weiss argues that the superior court erred in approving a settlement that “is not legally enforceable.” The settlement agreement provides:*

*By this agreement, the parties stipulate to a mutual dismissal of all claims and defenses, and acknowledge that the trust is reconstituted in accordance with State v. Weiss, 706 P.2d 681 (Alaska 1985). The provisions of . . . HB 201 . . . constitute material terms upon which the plaintiffs have agreed to a dismissal and acknowledged that the trust is reconstituted. If the Legislature materially alters or repeals any of those provisions, the plaintiffs’ sole remedy is a new action alleging that the mental health trust has not been adequately reconstituted and to seek such relief as*

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<sup>30</sup>HB 201 is a legislative bill passed during the 18th Legislative session (1993-1994) containing statutory provisions authorizing the Authority.

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*may be appropriate in light of the plaintiffs' claims. In light of the dismissal of each parties' [sic] claims, no modification of this agreement may be made except in writing signed by all the parties. Nothing in this section shall limit any party's right to enforce this agreement or applicable state statutes.*

The Superior Court noted in its decision granting final approval that “nothing in HB 201, the Settlement Agreement, or this decision can prevent a future legislature from passing legislation affecting the trust, but there are remedy provisions if this happens and deterrents exist.” The court stated that, in the event of such legislative action, the class can move for relief from judgment under Civil Rule 60(b)(6).<sup>31</sup> The trial court also relied on the expectation that the Authority, as an advocate for the trust, will:

*actively oppose any attempt by the legislature to make a material change in the terms of the settlement and remind the legislature of the possibility of another long and costly lawsuit against the State. The Trust Authority may also be in a position to influence the governor to veto any legislation which makes a material change in this settlement.*

In its *Dismissal Order* of December 13, 1994, the Superior Court stated:

*In the event the Legislature materially alters any of these legislative enactments, the plaintiffs may seek relief from the judgment dismissing this case, pursuant to Alaska Civil Rule 60(b)(6), and file a new action reasserting all of their claims including their original claims and the claim that the mental health lands trust has not been adequately reconstituted. The dismissal with prejudice will not bar these claims.*

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<sup>31</sup>Civil Rule 60(b)(6) states that a court may grant relief from a final judgment on a reason justifying relief. Relief under this rule is considered extraordinary.

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The court went on to state that:

*A material change of the settlement agreement by the legislature would thus present one of the narrowly defined situations that clearly present “other reason[s] justifying relief” under Rule 60(b)(6).*

The legislative changes contained in the Authority’s draft legislative bill, if adopted by the legislature, represent, in the words of the Alaska Supreme Court, “a material change in the settlement agreement.” In the quotation from the court’s opinion above, the Supreme Court held that, under the Settlement Agreement, the provisions of HB 201 “constitute material terms upon which the plaintiffs have agreed to a dismissal and acknowledged that the trust is reconstituted.”

Therefore, the audit concludes that proposed changes to the Authority’s statutes, if enacted, present substantial risk of provoking successful litigation to nullify the changes.

**Trust asset management policies do not fully comply with State investment laws and industry best practices.**

Trust management policies provide the foundation for the board of trustees’ decision-making. An investment firm was hired to evaluate the Trust asset management policies (summarized in Exhibit 8 on page 27) for compliance with State laws, including the Uniform Prudent Management of Institutional Funds Act (UPMIFA),<sup>32</sup> Alaska Uniform Prudent Investor Act (UPIA),<sup>33</sup> and widely observed best practices applicable to institutional investors of State land trusts.<sup>34</sup> The investment contractor’s report is included in Appendix B to this report.

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<sup>32</sup>Alaska Statute 13.65.

<sup>33</sup>Alaska Statute 13.36.225 - 13.36.290.

<sup>34</sup>The investment laws and industry best practices are summarized in Appendix A.

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## Exhibit 8

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### Asset Management Policies: AMPS and RMS

The Trust asset management policies are outlined in two documents: the Asset Management Policy Statement and Resource Management Strategy. The Authority created the Asset Management Policy Statement (AMPS) to delineate the asset management philosophy and practices for assets, both cash and non-cash, entrusted to the board of trustees. The Resource Management Strategy (RMS), created by the TLO to address its regulation 11 AAC 99.090(c) and approved by the board, outlines the long-term asset management strategy that establishes goals for managing Trust land assets by the TLO.

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Source: AMPS and RMS.

The contractor concluded that the Trust policies fall short of best practices in several areas discussed in detail below. Deficiencies center on the policies' lack of an entity-wide perspective that addresses the entire Trust asset portfolio, lack of guidance for the commercial real estate investments completed through the TLO, and absence of a rationale for using the TLO as a commercial real estate investment manager at the time the investment decisions were made. The audit recommends the Authority's board of trustees work with the Authority's and TLO's management to revise the AMPS and RMS to incorporate industry best practices and facilitate compliance with State investment laws. (Recommendation 3)

- **Lack of entity-wide perspective limits effective oversight, cost control, and prudent diversification of trust asset portfolio**

The contractor's significant, overarching concern was the lack of an entity-wide focus in the AMPS. Best practices, including UPMIFA and UPIA, require the Trust's cash and non-cash assets be considered as a single portfolio when establishing investment policies in order to apply prudence at the portfolio level and move toward a diversified asset allocation. The AMPS fails to

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outline objectives of the aggregate assets, including a stated asset allocation strategy, risk tolerance, and monitoring guidelines incorporating both cash assets and non-cash assets. The AMPS' lack of an entity-wide focus challenges the board's ability to fulfill its fiduciary responsibility in aggregate oversight, cost control, and prudent diversification of all Trust assets.

- **Lack of guidance for TLO's commercial real estate investments**

The contractor concluded that the AMPS and RMS were not adequate to effectively guide commercial real estate investment activities during the audit period. A best practice policy should be sufficiently specific to offer fiduciaries clear guidance on roles and responsibilities for key stakeholders and allow policy documents to guide investment decisions. The AMPS and RMS lack guidance regarding the pursuit of commercial real estate investment activities managed by the TLO in the following areas:

- o *Fit within the broader asset portfolio.* Both policies fail to consider the total Trust exposure to commercial real estate investments via cash and non-cash assets (specifically real estate investments already managed as part of the APFC's cash portfolio).

- o *Allowable or restricted investments.* There is no indication of the reason, the location, the timing, or the size of investments to be made or not made.

- o *Clearly articulated diversification guidance.* The RMS offers fiduciaries no clear guidance on what constitutes sufficient diversification and lacks clarity defining diversification by geography, sector, and economically sensitive market segments. The statements included in the RMS are too vague to provide a framework for reasonable diversification decision-making. Additionally, the AMPS fails to view TLO-managed commercial real estate investments and APFC-managed trust assets together as a single portfolio when evaluating diversification or duplication.

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o *Documented performance evaluation guidelines.* In 2015, four years after purchasing the first commercial real estate investment, the AMPS was revised to incorporate a paragraph addressing “Performance Expectations” specific to the TLO-managed commercial real estate investment activities which stated, “The performance of direct private equity real estate will be annually evaluated using an index or indices determined by the resource management committee.” However, the RMS offers no stated benchmark against which commercial real estate investments are to be evaluated, and in reviewing the TLO Annual Report for each fiscal year 2013 through 2016, no indices were provided for performance evaluation. Additionally, the 7.5 percent hurdle rate that was stated in the 2013 RMS was revised in the 2016 RMS to state “a hurdle return rate for investment will vary based on the needs of the Trust and the Permanent Fund’s projected 10 year return.”

o *Appropriate performance measures.* The RMS states that, for purposes of evaluating the success of the investment plan, the primary measurement should be the cash-on-cash percent of return because of “the income nature of the investment returns.” This runs contrary to best practice guidance<sup>35</sup> that portfolio performance should be measured on a total-return basis, considering both capital appreciation and income. Given the illiquid nature of real estate, the Chartered Financial Analyst Institute (CFA Institute) has established comprehensive best practice disclosure guidance specific to real estate reporting. This guidance includes requiring since-inception internal rates of return (IRR) be presented through each annual period end, along with a since-inception IRR for a benchmark that must reflect the investment mandate, objective, or strategy, and be presented for the same time period.

o *External valuations.* The frequency of ongoing external property valuations to facilitate prudent monitoring was not addressed in the RMS. The CFA Institute highlights the best

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<sup>35</sup>The best practices are outlined by the Western States Land Commissioners Association and Chartered Financial Analyst Institute.

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practice use of an independent third party for asset valuations to ensure inputs are reasonable to determine fair market value.<sup>36</sup>

o *Consideration of costs in calculating returns.* The RMS does not include a requirement to consider the management costs in the evaluation of commercial real estate investment performance. The CFA Institute has published best practice guidance for asset owners, which requires net of fees returns that reflect all costs of management of the assets. The CFA Institute recommends that in addition to all investment management costs, such costs:

*may also involve a pro rata share of overhead and other related costs and fees, including data valuation fees, investment research services, custodian fees, pro rata share of overhead (such as building and utilities), allocation of non-investment department expenses (such as human resources, communications, and technology), and performance measurement and compliance services.*

- **Inadequate rationale for using TLO as commercial real estate investment manager**

There was neither a clearly stated policy nor supporting rationale for the decision to use the TLO as the commercial real estate investment arm of the Authority at the time the investment decisions were made. Although there was no documented rationale, one of the Authority's objectives was to increase Trust income (see Exhibit 9 on page 31). The contractor concluded that income needs alone do not constitute a prudent investment rationale for using the TLO to drive direct real estate exposure over other options (such as investing in a diversified APFC portfolio).

Creation of a national direct commercial real estate investment program using TLO may, in fact, generate additional revenue; however, discussion and documentation of that fundamental

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<sup>36</sup>In review of the property records, the audit noted that the seven commercial real estate investments were valued using independent appraisals or broker opinions of value; however, these practices were not documented in the RMS or other policy documents.

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decision and the rationale for it set forward in a comprehensive fashion is a critical gap in the AMPS.

## Exhibit 9

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### Aggressively Generating Income Not a Prudent Investment Rationale

During the January 27, 2016, meeting, the Authority's board of trustees approved a motion directing the TLO executive director:

*to develop and present to the trustees, as soon as possible, [...] a plan to generate annually from the Trust noncash assets an amount of spendable income equal to or exceeding the spendable income generated from the Trust cash assets. The plan should define a strategy for achieving the income target as quickly as possible, but no later than 2035.*

In conjunction with the above motion, the TLO 2016 Annual Report cover letter stated:

*The TLO has been directed by the Trustees to develop and implement a plan to quintuple the income revenue generated by the TLO within 20 years. In order to achieve this goal, the TLO is aggressively pursuing opportunities to produce revenue wherever they present themselves.*

Aggressive income generation is an inappropriate investment goal from the perspective of an institutional investor for several reasons. The investment contractor noted that income needs do not constitute a prudent investment rationale to explain the drive for direct real estate exposure. Additionally, generating this level of revenue “as quickly as possible” is uncertain without incurring substantial risk. The investment in real estate of the magnitude necessary to meet the income goal would significantly increase the real estate exposure of the entire portfolio, decrease the diversification, and introduce unnecessary risk to long-term returns. Finally, a goal of a perpetual trust should be to preserve the intergenerational equity rather than achieve an “income target as quickly as possible.”

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Source: Board meeting minutes, TLO reports, and Appendix B.

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**Policies and regulations enabling the Authority to use Trust cash principal for commercial real estate investments through the TLO violate Authority statutes.**

Evaluating the Authority’s and TLO’s policies and regulations for compliance with statutes was an objective of the audit. The requirements to adopt regulations by the Authority and DNR are outlined in AS 47.30.031 and AS 38.05.801(c), respectively. Alaska Statute 47.30.031(a) requires the Authority’s regulations to be “consistent with state law” and AS 38.05.801(c) requires the DNR regulations to implement the statutes.

Authority policies evolved over time to allow for the use of cash principal outside of the APFC. In 2003, in accordance with 11 AAC 99.090(c), the TLO adopted a *Long Term Asset Management Strategy* allowing the Trust to acquire lands, structures, and resources. In October 2004, an amendment to regulation 20 AAC 40.700 specified that the funding mechanism for the land acquisitions and development activities was “receipts from the management of trust land.” While this regulation did not specify that TLO could use Trust land receipts attributable to principal (rather than income), the board of trustees interpreted this regulation as the authority to use cash principal outside of the APFC.

The AMPS, adopted by the board of trustees by reference in 20 AAC 40.600, was revised in 2009, 2011, and 2015 to clarify the use of cash principal for commercial real estate investments and development activities through the TLO. In those revisions, the AMPS language moved away from the “use” of the cash principal to the concept of exchanging one principal asset for another. Additionally, the use of cash principal was defined as “temporary” under the notion that the Authority’s board of trustees may direct the use of these funds on a short-term basis before cash principal is permanently transferred to the APFC.

The RMS<sup>37</sup> maintained consistent language in its 2013, 2015, and 2016 editions, allowing TLO use of land management receipts attributable to principal for commercial real estate investments and development activities outside the APFC:

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<sup>37</sup>RMS superseded Long Term Asset Management Strategy.

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*Revenue generated from the disposal of Trust assets (i.e. sale of land or royalties from resource extraction) must be reinvested, either with the Permanent Fund or through investment by the Trust in other principal assets that will safeguard the value of the asset and/or produce income for the Trust.*

Policies and regulations are used to interpret and implement the existing statutes. As already concluded, the Authority's diversion of cash principal from the APFC for other activities violated statutes. Since the practice of using cash principal for commercial real estate investments through the TLO is not supported by statute, by extension, the policies and regulations discussed above that justify this practice also violate statutes.

**Commercial real estate investments are more appropriately and efficiently carried out by the APFC.**

The audit concludes that commercial real estate investments are more appropriately and efficiently carried out by the APFC and recommends that the Authority's board of trustees discontinue investing in commercial real estate investments through the TLO. (Recommendation 1) The conclusions are supported by the following:

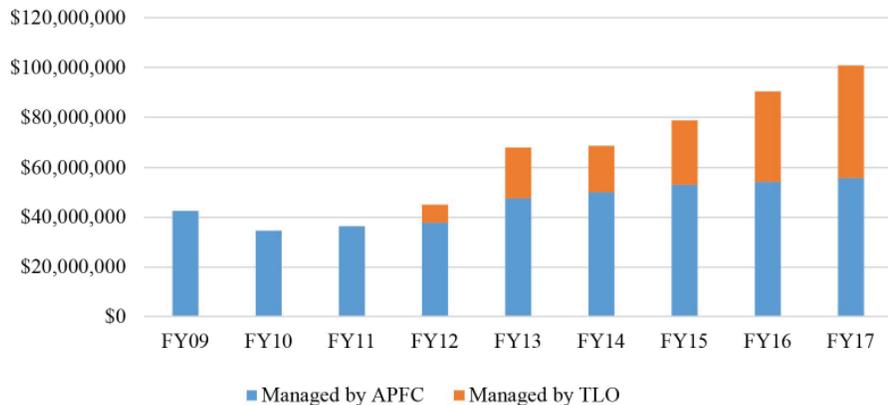
- **Having two investment programs is inherently inefficient and inflates administrative costs.**

The TLO's commercial real estate investment program on a conceptual level duplicates the APFC's real estate investments. Based on the Authority's FY 17 financial statements, the Trust's investment portfolio managed by the APFC included \$56 million in directly owned real estate, while TLO managed \$45 million (net of debt) in additional commercial real estate investments. Exhibit 10 on page 34 shows the growth of Authority's real estate investments since FY 09.

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## Exhibit 10

### Growth of Authority Commercial Real Estate Investments FY 09 through FY 17



Source: Authority's audited financial statements.

TLO's management of commercial real estate investments is performed by one property manager, who spends most of his time administering seven commercial real estate investments and property management companies. Additionally, the senior resource manager of real estate<sup>38</sup> and TLO executive director spent a portion of their time overseeing commercial real estate investment management and acquisitions. TLO also contracted with external property management companies, a private CPA firm, an attorney, and a variety of due diligence vendors.

The portion of TLO personnel costs associated with commercial real investment management could have been avoided if the APFC performed the real estate investment function. Additionally, because the APFC invests on a much larger scale than the TLO, the transaction costs (attorney, due diligence, etc.) per dollar of investment would likely have been less. Because the TLO does not comprehensively track direct and indirect costs associated with management of the seven commercial real estate investments, the exact amount of duplicated costs could not be calculated.

<sup>38</sup>As of July 2017, no longer employed by the TLO.

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State investment law, as documented in the UPMIFA, requires prudence in incurring investment costs, authorizing “only costs that are appropriate and reasonable.” The additional costs incurred by the TLO for the purpose of managing and acquiring commercial real estate investments do not appear to be in accordance with this principle.

- **The TLO does not have access to the same level of resources and institutional knowledge as the APFC.**

The contractor concluded that the APFC was better equipped than the TLO to manage an institutional quality commercial real estate investment portfolio due to its access to external resources. The investment contractor compared the real estate asset management resources of the TLO and the APFC and found that internal staff resources (team size, industry experience, backgrounds, etc.) were not identical, but of similar depth across the two organizations. However, the contractor found that the depth of APFC’s commercial real estate advisor relationships appear superior to the TLO’s in several aspects that are often critical to the sustained long-term performance of a successful commercial real estate investment program. The APFC’s capabilities include deal sourcing, a far-reaching information pipeline, and access to additional human capital (i.e. real estate investing expertise). Additionally, the contractor regarded the APFC’s technology resources (i.e. monitoring software) as superior to TLO.

The contractor also found that APFC’s investment policies were superior. The Authority’s policies offer broad, arguably vague, guidance to fiduciaries on: permissible investments, risk guidelines, and controls; portfolio growth and performance objectives; and lack quantifiable benchmarks for evaluation of progress toward the achievement of these objectives. The APFC policy documents, in contrast, contain specific performance objectives, risk and diversification tolerances, and long-term objectives of the real estate investment portfolio.

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- **Commercial real estate investments via the TLO increased the Authority’s real estate concentration, thereby reducing the Trust portfolio diversification.**

As documented in Exhibit 11, the Authority’s current policies do not have a clear limit on the size of commercial real estate investments made through the TLO. Lack of a limit, in part, resulted in real estate concentration growing every year, which decreased the overall Trust portfolio’s diversification.<sup>39</sup> In contrast to the Authority’s policies that have no limit on commercial real estate investments, the APFC investment policies establish a specific limit (e.g. 11 percent for 2018.)

#### **Exhibit 11**

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### **Evolution of Commercial Real Estate Investment Size Parameters in RMS**

The asset allocation criteria in the RMS from 2013 to 2015 targeted a \$40 million investment in real estate, which would be combined with a targeted \$40-80 million in debt.

In 2016, however, invested dollars approached the \$40 million target allocation, and the RMS asset allocation criteria language was modified by removing mention of a targeted investment, and instead stated, “The principal investments in income property will be determined by trustees on a case-by-case basis.”

The change to the RMS indicates that real estate investment activities drove the policy revision, rather than the RMS guiding the appropriateness of additional investments for the portfolio.

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Source: Appendix B.

<sup>39</sup>The Trust portfolio includes both land assets managed by the TLO and cash assets managed by the APFC. Based on the *Principles of State Trust Portfolio Management* created by the Western States Land Commissioners Association, “land, minerals, buildings, and financial assets are components of a single portfolio, and, to the extent possible, should be managed as a single portfolio.”

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**While the TLO’s real estate asset-level due diligence followed best practices, portfolio-level due diligence fell short of institutional standards.**

The Authority’s total commercial real estate investment concentration more than doubled, from seven percent in FY 11 to 15 percent in FY 17, before considering the land granted to the Trust and valued in the financial statements at \$1 per acre. This increase was primarily due to commercial real estate investments made through the TLO.

When reviewing the TLO-managed commercial real estate investments, the contractor noted high concentration in the Western and Southern United States (especially in Texas), and a concentration of office-type properties. This concentration presents the potential for overlapping market-specific exposures that could reduce diversification and introduce unnecessary risk to long-term returns.

Real estate due diligence is a buyer’s investigation of the various aspects of a property before making an offer or within a specific timeframe between entering into the contract and closing. As part of this audit, an investment firm was hired to evaluate the due diligence completed by the TLO on seven commercial real estate investment properties.<sup>40</sup> Commercial real estate investments were evaluated against two broad categories of due diligence: asset-level and portfolio-level. The audit found that asset-level due diligence generally complied with institutional investor best practices; however, portfolio-level due diligence fell short.

- **Asset-Level Due Diligence**

This form of due diligence identifies whether investments in specific properties allow investors to access above-average risk-adjusted returns in a targeted commercial real estate investment space. As such, asset-level due diligence is extensive and includes procedures performed as part of investment screening, the approval process, and deal pursuit.

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<sup>40</sup>The complete contractor’s report is available in Appendix B.

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The investment contractor's evaluation of due diligence conducted for each property concluded that due diligence generally conformed to best practices. However, the contractor noted a consistent lack of documentation outlining the process and resources involved in TLO's idea generation. TLO documentation for the commercial real estate investment purchases provided only a brief summary of the properties and did not go into detail as to why the specific properties were selected over other comparable options. The lack of evidence of a sustained source of, and robust filter for, ideas for both acquisitions and divestitures (when necessary) caused the contractor to question TLO's ability to sustain a successful commercial real estate investment program over the long term.

- **Portfolio-Level Due Diligence**

This form of due diligence determines the appropriateness of a commercial real estate investment property (or strategy) in the context of a broader portfolio of investments, given a set of stated investor goals, restrictions and sensitivities. At the institutional investor level, best practices for the purchase of new assets and their inclusion in commercial real estate investment portfolios should incorporate the following elements of analysis: alignment with client goals, analysis of risk, analysis of diversification potential, and a clear policy statement guiding execution.

The investment contractor generally observed a lack of documentation in all elements of portfolio-level due diligence. Each of the four portfolio-level due diligence areas is described below:

1. *Alignment with client goals:* There is lack of support regarding the alignment of the commercial real estate investment transactions completed through the TLO with the Authority's investment goals and objectives. Authority policy documents lack guidance on an entity-level asset allocation strategy, as well as the structuring of the real estate asset class.<sup>41</sup>

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<sup>41</sup>Structuring of the real estate asset class is a balance between investments in existing, high occupancy, and generally stabilized properties in predominantly primary markets, versus investments that require repositioning, releasing, or redevelopment.

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Relevant policies fail to offer clear guidelines on appropriate risk/return attributes from individual investments or at the asset class level, and offer no diversification objectives for those assets managed by the TLO directly or as a broader portfolio integrated with those assets managed by the APFC. This gap in policy development is a critical oversight in the Authority's ability to assess any single investment's value-add to the portfolio.

2. *Analysis of risk:* The analysis on risk control for TLO-managed commercial real estate investments was completed mainly through various types of cash flow modelling or other stress testing at the property level. However, there is little evidence of analysis at the portfolio level to support a focus on prudent risk control. Furthermore, there is no documentation supporting the optimization of the risk-return tradeoff at the portfolio level.
3. *Analysis of diversification potential:* There is little evidence of consideration for diversification potential within the TLO commercial real estate investments. The RMS offers fiduciaries no clear guidance on the appropriate level of diversification across geographies or property sectors. Additionally, the Authority's policies lack an entity-wide view to evaluate diversification and duplication potential of the TLO-managed commercial real estate investments when considering assets managed by the APFC. The lack of an integrated view of the Authority's assets at the portfolio level may result in unintended portfolio exposures.
4. *A clear policy statement guiding execution:* There is no clearly stated policy nor formally documented supporting rationale for the decision to use the TLO as the commercial real estate investment arm of the Authority versus relying on the larger, broader, and more diversified capabilities of the APFC. Moreover, there is no clearly documented rationale at the Authority's policy level that supported the

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investment of real estate proceeds (i.e., the proceeds from the Authority's land holdings) in more real estate (i.e. commercial real estate investments) rather than deepening the degree of diversification by allocating these proceeds to the Authority's cash principal managed by the APFC. Lack of clearly documented policy decisions and the underlying rationales does not constitute best practice from an institutional investment management perspective.

The audit recommends the Authority's board of trustees revise the AMPS and RMS to incorporate industry best practices and facilitate compliance with State investment laws. (Recommendation 3)

**In conducting its business, the Authority's board of trustees did not comply with the Alaska Executive Branch Ethics Act, Open Meetings Act, and bylaws.**

The audit examined 175 board and committee meetings held from FY 12 through FY 17, reviewed personnel email communications, and interviewed trustees and management. Based on these procedures, the audit concludes that, on many occasions, the board of trustees failed to comply with the Alaska Executive Branch Ethics Act, Open Meetings Act, and the Authority's bylaws when conducting its business (see Exhibit 12 on page 41 for the summary of these laws). The pattern of noncompliance is troubling given the responsibility of the Authority to administer the Trust in the interest of the beneficiaries in an open manner. The actions of the board diminished the integrity of the governmental process by impeding the people's right to be informed. Furthermore, actions taken contrary to the Open Meeting Act may be voidable and expose the board of trustees to the risk of litigation.

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## Exhibit 12

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### Legal Foundation for Conducting Board Business

The importance of conducting a public entity's business in an open and fair manner is embodied in the Authority's bylaws and in several State statutes. In accordance with the bylaws, the Authority board of trustees are required to comply with the Alaska Executive Branch Ethics Act. Additionally, meetings of the board and its committees are subject to the Open Meetings Act and the proceedings are governed by *Robert's Rules of Order*.

Per the Alaska Executive Branch Ethics Act, "a fair and open government requires that executive branch public officers conduct the public's business in a manner that preserves the integrity of the governmental process and avoids conflicts of interest."

The Open Meetings Act requires actions and deliberations of executive branch employees to be conducted openly and that the people's right to remain informed be protected. Appendix A of this letter provides a summary of the laws and bylaws used by the audit to evaluate board of trustees' operations.

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Source: Alaska Executive Branch Ethics Act, Open Meetings Act, and the Authority's bylaws

Evidence showed that multiple trustees were, at times, intentionally trying to avoid discussing board business in a public manner. Other times, evidence showed the board of trustees failed to recognize the importance or need for adhering to the laws when conducting and noticing its meetings. Noncompliance included the following:

- **Hosting periodic retreats for discussing board business without retaining meeting minutes**

On numerous occasions, the Authority's board participated in retreats to discuss board business. The audit was not able to determine the total number of retreats held during the review period; however, it was noted that hosting retreats was a consistent

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practice of the board.<sup>42</sup> The retreats meet the statutory definition of a meeting.<sup>43</sup> While some retreats were public noticed, meeting minutes were not documented or retained. Retaining meeting minutes is required by the Authority's bylaws.

In at least two instances, the audit found that some board members expressed an intent to participate in retreats to avoid discussing topics during board meetings. In one instance, a trustee sent an email to the entire board requesting a retreat and stated:

*I would like to schedule a short (@ 2 hr) retreat discussion in conjunction with our [...] board meeting in order to give [employee] an opportunity to provide information about the outlook for development of Trust resources that **should not be discussed publicly** & for trustees to have an opportunity to discuss these matters privately. [Emphasis added]*

In another instance, a discussion to hold a meeting, which was not public noticed, between several trustees and personnel included the following verbiage:

*it would be useful to have a meeting [...] to discuss a couple of other options we have for taking action. It **isn't clear to me that we need to notice the meeting and it should be held privately** in any case because having a public discussion of the issues 'might tend to prejudice the reputation of' one or more individuals and materially and negatively affect the Trust's finances and ability to develop [the project]. [Emphasis added]*

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<sup>42</sup>A review of the board meeting minutes found that retreats were discussed during 18 of 175 meetings between FY 12 and FY 17. Additionally, four retreats were public noticed but not discussed at the board meetings.

<sup>43</sup>Open Meetings Act codified in AS 44.62.310(h)(2)(A) defines a meeting as a gathering of members of a governmental body when "more than three members or a majority of the members, whichever is less, are present, a matter upon which the governmental body is empowered to act is considered by the members collectively, and the governmental body has the authority to establish policies or make decisions for a public entity."

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- **Discussing board business via email without including all board of trustees**

A review of employee email records showed instances where some trustees discussed board business via email. A few emails included discussions intended to conceal information from other board members.

In one example, three trustees received via email a draft executive summary of a consultant report commissioned by the board. In the email discussion of the consultant report, a trustee, who received a copy, stated, “I personally consider the draft to be unacceptable, and the question being whether to continue with this consultant or not.” As a result, neither draft nor final report was shared with the full board as of October 2017, even though the contractor was paid the full price for the services. Based on the meeting minutes, a trustee, who did not receive the report, opposed this decision.

Meeting minutes state<sup>44</sup>:

*he objects to that way of doing business because the board should have the right to review the draft document [...] [He] clarifies that report was authorized by the board of directors and is supposed to be coming back to the board for the purposes of trying to guide this organization on behalf of the Trust beneficiaries, which seems to be forgotten most of the time here, unfortunately. [...] It seems to be inappropriate that one or two people on the board suddenly seem to have the authority to act on behalf of the board to determine what is in the report and what might be missing.*

In another example, a \$1.375 million Request for Proposal (RFP) for a multi-year project was issued without approval and knowledge by the entire board. The RFP was discussed by several board members in the emails without involving all trustees. A

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<sup>44</sup>From the January 5, 2017, Resource Management Committee meeting minutes.

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trustee who was not aware of the RFP stated on the record<sup>45</sup> that he was disappointed that a \$1.375 million contract was issued without the board being aware.

In a third example, the former chief executive officer (CEO) was demoted to the position of program manager and an interim CEO was appointed during the October 26, 2016, board of trustees meeting based on earlier arrangements made by a group of trustees. Because several trustees were not aware of the earlier arrangements and were not familiar with the candidate for the interim CEO position, concerns were voiced about the motions made during the board meeting. One trustee stated that “the whole Board of Trustees have not talked about what the problem is, been able to ask [the former CEO] questions as to why he is resigning.”

The board minutes show another trustee questioned the actions. Minutes state:

*appointing someone he never heard of, there is no resume, and he is being asked to vote on retaining this person as the executive director for the Trust. He finds that unacceptable. The normal process would be to advertise for applicants to fill a position. The board would have the ability to review all of the applicants and go through a selection process to determine who is the best-qualified individual to fill the now-vacant position, and then the board would vote on hiring that individual. He continues that the board has been closed out of the process of reviewing and making a selection from the best-qualified applications. He states that he does not see how the Mental Health Trust beneficiaries are well served at all by that type of action. He thinks it is totally inappropriate, if not illegal, for that to occur in that manner.*

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<sup>45</sup>From October 26, 2016, Finance Committee meeting minutes.

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- **Participating in working lunches without retaining meeting minutes**

Based on a review of the meeting minutes during the audit period, the Authority's board participated in at least two working lunches to discuss board business. Although working lunches meet a statutory definition of a meeting, no meeting minutes were retained. Retaining meeting minutes is required by the Authority's bylaws.

- **Considering 24 hour public notice sufficient**

During the September 3, 2014, board meeting, trustees determined that a public notice of 24 hours prior to a meeting was adequate. This determination is contrary to AS 44.62.310(e), which requires a reasonable public notice for all meetings. The review of public notices posted in the Online Public Notice system from FY 12 through FY 17 showed that 29 board and committee meetings were noticed within 24 hours. Twenty-four hours is not a reasonable notice, as it does not give enough time for interested parties to participate.

- **Making improper motions to go into executive sessions**

On several occasions, the Authority went into executive session using a motion that did not comply with State law. Alaska Statute 44.62.310(b) requires that a motion to go into executive session clearly and with specificity describe the purpose of the proposed session. The audit found that, in some instances, motions made by the board lacked detail to enable the public to understand why the executive session was necessary. For example, on January 3, 2013, the Resource Management Committee went into executive session with a motion "to discuss matters which are of a financial impact to the Trust." This language did not clearly and with specificity describe the purpose of the session. In another example, on June 30, 2015, the Authority described the purpose of executive session with a single word — "personnel," again not

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complying with provisions of AS 44.62.310(b). Furthermore, on January 25, 2017, a motion stated that the session would take up an issue that “may have financial import on the body.”

The audit recommends the Authority’s board of trustees and CEO design and implement written procedures to ensure trustees comply with State law and Authority bylaws in the conduct of the Authority’s business. (Recommendation 4)

## Several business and professional relationships created an appearance of related party transactions.

Determining whether any Authority or TLO transactions could be considered less than arm’s length was an objective of the audit (Exhibit 13 provides the audit’s definition of “arm’s length transaction” and “related parties”). While there were no less than arm’s length transactions identified, the relationships identified below give the appearance of transactions between related parties and could raise question as to the propriety of actions taken.

### Exhibit 13

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#### Less than Arm’s Length Transactions

An “arm’s length transaction” is defined as a transaction negotiated by **unrelated parties** acting in their own **independent interests**. A “less than arm’s length transaction” is a transaction between related parties. “Related party” is an entity or individual that has a direct/indirect financial or personal interest in another entity or individual.

The close relationship between related parties creates potential for actions that benefit the individuals involved as opposed to the organization. In the State government, rules designed to prevent the conflict of interest are codified in the Alaska Executive Branch Ethics Act (AS 39.52), summarized in Appendix A.

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Source: Adopted based on the audit standards and best practice guides.

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1. The former TLO executive director engaged a friend to represent TLO as its buyer's agent in the acquisition of two investment properties. Records show that the friend was paid by the seller approximately \$370,000 in commissions as a part of these transactions. The relationship was not formally disclosed. Alaska Statute 39.52.120(a) prohibits a public officer from using an official position to intentionally secure unwarranted benefits for any person. While no State of Alaska funds were paid to the executive director's friend, the friend was compensated and thus financially benefited from the Trust transactions. The close relationship between the executive director and the buyer's agent increases the potential for fraud or abuse.
  2. The former TLO trust resource manager owned a property management corporation with a person that also served as a TLO contractor managing Trust properties and who represented the Authority in the purchase of two commercial real estate investments. Alaska Statute 39.52.170(a) does not allow a public employee to engage in employment outside the State agency if the outside employment is incompatible with the proper discharge of official duties. Additionally, a public employee engaging in employment outside the State agency is required to annually report the outside employment to the employee's designated ethics supervisor. In this case, the employee did not disclose the business name and affiliation with the contractor to the ethics supervisor in the annual ethics disclosure forms, providing only vague details of the outside self-employment. When the relationship was discovered, TLO management conducted an internal review. As a result of the review, the contractor transferred her share of ownership to the TLO employee, making the employee the sole owner of the corporation. This relationship did not meet the definition of a related party transaction because the TLO employee was not responsible for procuring the associated party to manage the trust properties. Additionally, the employee did not have formal decision-making

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authority to select the associated party as the buyer's agent in commercial real estate investment acquisitions. However, the close financial relationship of the TLO employee and a TLO contractor creates the appearance of related parties.

3. The former TLO executive director hired the subsidiary of the executive director's prior employer to continue serving as property manager for a newly acquired commercial real estate investment property. The subsidiary received at least \$396,000 to manage TLO properties. According to TLO's management, the TLO did not follow the State Procurement Code (AS 36.30) in selecting this entity, and no procurement records could be located. Selection of the entity without following a documented reasonable procurement process increases the risk that the entity was not chosen in an open, fair, ethical, and transparent manner.
4. The Authority's former CEO served on a nonprofit organization's board while the organization received \$4 million in grants from the Authority from FY 07 through FY 15. The service on the board was mentioned during three of the Authority's board meetings between FY 11 and FY 17. However, no formal disclosures were made during the specific board meeting times dedicated to ethics disclosures or to the designated ethics supervisor. The lack of consistent disclosure increases the risk that the chief executive officer could have exerted undue influence on the grant award decision-making process.
5. A former trustee did not consistently disclose a spousal relationship when the spouse testified during board meetings. When the issue of disclosure was brought up at a board meeting, the trustee stated that the relationship was disclosed on several previous occasions and the trustee was not convinced it needed to be disclosed again. Additionally, the trustee believed that the spousal relationship did not require disclosure since the Authority's actions did not have

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an effect on his spouse's income. The lack of consistent disclosure creates a risk of undue influence over Trust business.

**There was no indication of material misstatement in the Authority's reporting of TLO-managed assets.**

Evaluating whether the Authority's TLO-managed assets were reported in the Authority financial statements in accordance with generally accepted accounting principles was an objective of the audit. The audit found no indication of material misstatement.

The Authority's financial statements issued from FY 09 through FY 17 received unqualified opinions from an external audit firm indicating that statements were prepared in accordance with generally accepted accounting principles. The asset classification, valuation and reporting appeared consistent with accounting standards. Note disclosures provided a high level summary of accounting policies that appeared to meet the applicable professional requirements.

As shown in Exhibit 14 on page 50, the TLO-managed assets were comprised of buildings and infrastructure, land and land improvements, corpus land (valued at \$1 per acre),<sup>46</sup> and commercial real estate investments. As of the end of FY 17, the largest TLO-managed asset based on the financial statements was commercial real estate investments net of mortgage valued at \$45.1 million. This amount was presented in the footnotes and was materially supported by Limited Liability Companies' financial records.

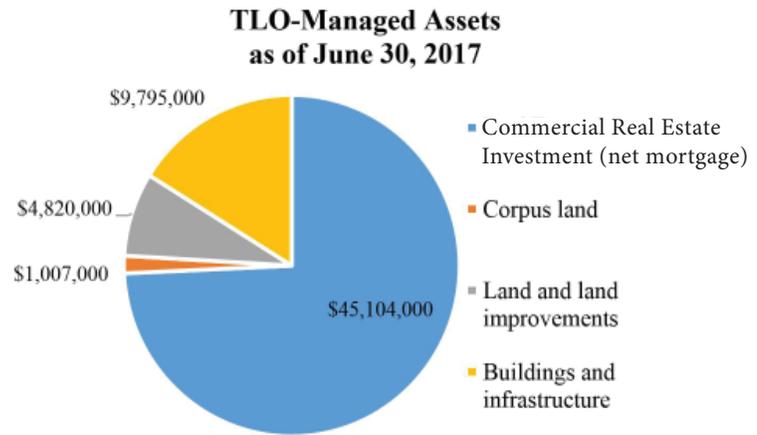
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<sup>46</sup>While the financial statements report the corpus land value at \$1/acre with the total corpus land value of approximately \$1 million, the TLO management reported that the actual value is approximately \$1 billion. However, because all corpus land was not appraised, the actual value could not be determined.

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**Exhibit 14**



Source: Authority's FY 17 audited financial statements

**The TLO spent a total of \$1.6 million in cash principal for Icy Cape mine exploration, and the board of trustees has approved another \$3 million for future exploration.**

An objective of the audit was to report on the use of Trust assets for the Icy Cape mine project. The Icy Cape property is located in a remote area in the Gulf of Alaska, about 75 miles northwest of Yakutat. In 1996, land and minerals ownership of the Icy Cape Block was transferred from the State of Alaska to the Authority. The TLO identified the Icy Cape Block as prospective for placer<sup>47</sup> gold and for associated heavy minerals (e.g. garnet, zircon, and rutile), and initiated the Icy Cape Gold and Industrial Heavy Minerals Project in July 2015. Exhibit 15 shows the Icy Cape Block Map with locations of analyzed samples in the eastern Icy Cape.

A motion to pursue mine operations was made at the Resource Management Committee<sup>48</sup> meeting on October 26, 2016.<sup>49</sup> However, as of the date of this audit, the TLO had only engaged in mineral exploration for the purpose of identifying the mineral potential of

<sup>47</sup> "Placer" refers to mineral deposits in the river bed containing valuable metals. Placer mining is extraction of valuable metals from placer deposit.

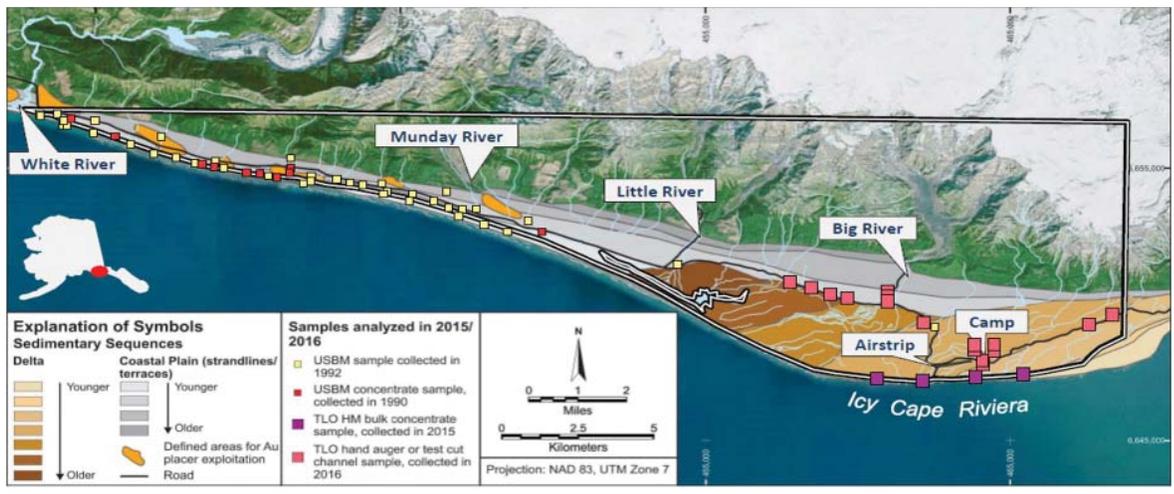
<sup>48</sup>The Resource Management Committee is a standing committee of the Authority's board of trustees. Based on the bylaws, the duties of this committee include developing policies and plans for protecting, enhancing, and managing the Trust's non-cash resources.

<sup>49</sup> During the board meeting, the committee approved several motions related to Icy Cape. One of these motions recommended that the board of trustees authorize the TLO's executive director to represent the Trust's interests in the Icy Cape Gold and Industrial Heavy Minerals project to ensure a successful operation, including, but not limited to, modification to the project, plan, sale of mined goods, financing or other capital considerations, and developing proposed joint venture partnerships at appropriate junctures. As a part of this motion, a trustee clarified that the trustee "wants all to realize that the trustees are approving going into a mining operation."

the land. As a part of the mineral exploration, TLO completed two phases of exploration and started a third phase, expending a total of \$1.6 million in cash principal as of December 2017.

**Exhibit 15**

**Icy Cape Block Map**



Source: Authority's FY 17 audited financial statements

TLO personnel reported that mineral exploration confirmed the existence of gold and heavy minerals in Icy Cape. To continue with the third phase, the board approved an additional appropriation of \$3 million in cash principal for asset enhancement (exploration activities) on October 27, 2017. After the completion of drilling, the fourth phase of the project will consist of a test mining operation with a pilot plant for producing gold and industrial heavy mineral products for sale.

The audit inquired with the DNR management to determine if Icy Cape operations were conducted “under those provisions of law applicable to other state land”<sup>50</sup> as required by statutes. The department’s management replied that:

<sup>50</sup>Alaska Statute 38.05.801(b)(1).

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*Although the TLO is doing more for mineral exploration in this project than other divisions in DNR would normally do, it is not unlike the efforts of the Division of Geologic and Geophysical Surveys conducting Aeromagnetic Resonance Surveys for other state lands to increase the knowledge of the mineral resources on other state lands. None of the mineral exploration activities conflict with other DNR practices.*

While the mineral exploration completed to date is in accordance with the TLO responsibility to manage Trust land, the use of Trust cash principal for Icy Cape exploration conflicts with statutes that require cash principal be managed by the APFC.

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# FINDINGS AND RECOMMENDATIONS

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## Recommendation 1

**The Mental Health Trust Authority’s (Authority) board of trustees should stop investing in commercial real estate through the Trust Land Office (TLO), consult with the Alaska Permanent Fund Corporation (APFC) on the treatment of commercial real estate investments acquired to date via TLO, and transfer the Trust Authority Development Account’s (TADA) cash principal balance to the APFC.**

Cash principal was not transferred by the Authority’s board of trustees from the TADA<sup>51</sup> to the APFC for the period of November 2008 through December 2017. Instead of transferring the monies to the APFC, the Authority used \$39.5 million of principal proceeds from land management transactions to acquire commercial real estate investments via the TLO. Several commercial real estate investments were mortgaged and the mortgage proceeds (which are considered principal and included in the \$39.5 million) were not transferred to the APFC. Instead, the mortgage proceeds were used for additional commercial real estate investments. Furthermore, as of June 30, 2017, the TADA had an available balance of \$19.6 million of cash principal, which should have been transferred to the APFC.

Section 202(e) of the Alaska Mental Health Enabling Act (AMHEA), the federal act that established the land trust, states that “lands [...] may be sold, leased, mortgaged, exchanged, or otherwise disposed of in such manner as **the Legislature of Alaska may provide.**” [Emphasis added] Thus, the management of the Trust is subject to Alaska statutes promulgated by the legislature. Alaska statutes<sup>52</sup> clearly and unambiguously command that cash principal be managed and invested by the APFC. Per AS 37.14.031, principal includes “money received from the management of mental health trust land attributable to principal.”

The Authority’s board of trustees made the decision to use cash principal for commercial real estate investments based on a desire to generate additional income for the Trust and a desire for more control over income generation. In a letter to the legislative auditor dated September 11, 2017, the board of trustees stated that, per their understanding of statutes, commercial real estate investments fall within the TLO’s duties to manage Trust land assets. Trustees further stated that statutes allow for the temporary use of cash principal to acquire real property “as part of the Trust’s land base.” Although the board of trustees acknowledged that cash principal is statutorily required to be managed and invested by the APFC,

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<sup>51</sup>The TADA was designed as a holding account for the land management proceeds attributed to principal to facilitate at least quarterly transfers to the APFC.

<sup>52</sup>The following four statutes require the trust fund to be managed by the APFC: AS 37.13.300, AS 37.14.009, AS 37.14.033, and AS 37.14.035.

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the board justified the use of principal for commercial real estate investments stating that:

*Alaska's current statutes and regulations make clear that nothing should stand in the way of the Trust's goal of managing its assets in the best interest of its beneficiaries, as required by the 1956 Alaska Mental Health Trust Enabling Act. Land assets are not as productive if principal revenues are immediately invested in an account to which the trust thereafter has very restricted access as opposed to allowing short-term use of those funds to develop and thus enhance land assets.*

The above justification is insufficient. The AMHEA directs that the Trust should be managed as defined in statutes by the Alaska Legislature. Thus, violating Alaska statutes is contrary to AMHEA. Additionally, commercial real estate investments cannot reasonably be considered a temporary use of cash principal. Finally, the Authority's actions run contrary to the terms set out in the *State v. Weiss* settlement. The Authority's and the TLO's existence and specific roles are defined by the settlement that sets up the framework for managing the Trust and serving its beneficiaries. Managing a commercial real estate investment program is not an authorized role of the TLO per the settlement.

In 2017, the Authority proposed a statutory revision designed to authorize the use of cash principal for commercial real estate investments via the TLO and to ratify the commercial real estate investments made to date. The audit concluded that proposed statutory revisions constitute a material change to the current law and, if enacted, present a substantial risk of provoking successful litigation to nullify the changes. There was no evidence in public records that the terms of settlement were considered by Authority management or its board of trustees when discussing statutory revisions.

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As a result of the trustees' decision to invest cash principal in commercial real estate through the TLO, the Authority violated statutes, inflated trust costs, duplicated commercial real estate investment activities carried out by the APFC, and increased the risk of litigation.

We recommend the Authority's board of trustees discontinue commercial real estate investments through the TLO, consult with the APFC on the treatment of properties acquired to date, and transfer the TADA balance to the APFC. Possible options for addressing the existing TLO-managed commercial real estate investments include, in part:

- Creating a plan to divest the existing seven commercial real estate investments acquired through the TLO.
- Transferring the seven commercial real estate investments to the APFC to be absorbed into APFC's existing portfolio.
- Transferring the seven commercial real estate investments to the APFC to be managed as a separate portfolio of the Authority.

## Recommendation 2

**The Authority's board of trustees should fund future program-related investment (PRI) activities from the Trust income account and reconstitute the APFC with cash principal used on PRIs to date.**

The Authority used at least \$1.8 million in Trust cash principal funds from FY 07 through FY 17 to construct and develop PRI buildings.<sup>53</sup> Using cash principal for this purpose was not in accordance with the State statutes, which require the proceeds from sale or other disposals of Trust land to be managed/invested by the APFC.<sup>54</sup>

Trust income is the appropriate funding mechanism for developing PRI buildings. Alaska Statute 37.14.041(a)(1) states, "Money in the mental health trust settlement income account may [...] be used for [...] the awarding of grants and contracts in fulfillment of the authority's purpose to ensure an integrated comprehensive mental health program for the state." The PRI buildings leased to

<sup>53</sup>PRI buildings are trust properties acquired through intergovernmental transfers or constructed on trust land. PRI buildings do not constitute investments and are reported on the financial statements as capital assets.

<sup>54</sup>Alaska Statute 37.13.300, AS 37.14.009, AS 37.14.031, AS 37.14.033, and AS 37.14.035.

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beneficiary-serving organizations can be considered a contract for the purpose of ensuring an integrated comprehensive mental health program.

The board decided to use cash principal for the PRI buildings on the basis that PRIs would be a Trust investment, despite the fact that the buildings may provide below market returns. Additionally, the board of trustees preferred using principal funds rather than the Trust settlement income account, as using income would have reduced the annual amount allocated for grants to beneficiaries.

Using cash principal for developing PRI buildings violated statutes and had the effect of diverting principal from the APFC, which ostensibly reduced related investment income.

We recommend board of trustees fund future PRI activities from the income account and reconstitute the APFC with the amount of principal used on PRIs to date.

### **Recommendation 3**

**The Authority's board of trustees should work with the Authority and TLO management to revise the Asset Management Policy Statement (AMPS) and Resource Management Strategy (RMS) to incorporate industry best practices and facilitate compliance with State investment laws.**

Both Trust asset management policy documents, the AMPS and RMS, fall short of industry best practices. The AMPS does not provide guidance for the trust asset portfolio (cash and land) as a whole. Furthermore, neither the AMPS nor RMS provides a rationale for using TLO as the commercial real estate investment arm of the Authority or provides adequate guidance for the pursuit of commercial real estate investments through the TLO.

The Alaska Uniform Prudent Investor Act (UPIA)<sup>55</sup> and the Uniform Prudent Management of Institutional Funds Act (UPMIFA)<sup>56</sup> require investment and management decisions about an individual asset to be evaluated not in isolation, but in the context of the portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust and the institution. Furthermore, the *Principles of State Trust Portfolio Management* published by the Western States Land Commissioners

<sup>55</sup>Alaska Statute 13.36.230(b).

<sup>56</sup>Alaska Statute 13.65.010(e)(2).

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Association specifically states that in land trusts, “land, minerals, buildings, and financial assets are components of a single portfolio, and, to the extent possible, should be managed as a single portfolio.”

Insufficient guidance in the AMPS and RMS challenges the board’s ability to fulfill its fiduciary responsibility to provide oversight, control costs, and provide for the prudent diversification of all Trust assets. Additionally, lack of clear policies resulted in inadequate evaluation of commercial real estate investments at the portfolio level.

The AMPS and RMS fell short of best practices because the policies were modified to accommodate the desire of the board to pursue the commercial real estate investments through TLO rather than created as a cohesive overarching policy for all Trust assets. The Authority contracted with a consultant who identified the lack of an entity-wide asset allocation policy and made recommendations to correct the deficiencies.<sup>57</sup> However, the consultant report was not shared with all board trustees and the policy deficiencies were not addressed.

We recommend the board of trustees work with the Authority and TLO management to revise the AMPS and RMS to incorporate industry best practices and facilitate compliance with State investment laws. Specifically, the board should:

1. Create an organizational structure whereby evaluation of cash and non-cash assets are addressed by a single fiduciary body and incorporate an entity-wide view of all Authority’s assets. A best practice policy should view cash and non-cash assets as a single portfolio in order to apply prudence at the portfolio level and move towards a diversified asset allocation.
2. Develop and document an aggregate asset allocation policy.

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<sup>57</sup>On January 13, 2017, the Authority’s consultant submitted a 126 page comprehensive report, which reviewed the Authority’s policies and provided recommendations in the areas of governance, asset management policy, and asset allocation.

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## Recommendation 4

### **The Authority’s board of trustees and chief executive officer should design and implement written procedures to ensure trustees comply with the Alaska Executive Branch Ethics Act, the Open Meetings Act, and Authority bylaws.**

The Authority’s board may delegate management of the Authority’s assets; however, such delegation does not remove the board’s fiduciary responsibility for oversight of prudent diversification, monitoring, performance evaluation, and cost control for the aggregate assets.

The audit examined 175 board and committee meetings held from FY 12 through FY 17, reviewed personnel email communications, and interviewed trustees and Authority management. This review concluded that, in conducting its business, the Authority’s board of trustees violated the Alaska Executive Branch Ethics Act, the Open Meetings Act, and Authority’s bylaws. The violations included the following:

- Hosting periodic retreats for discussing board business without retaining meeting minutes;
- Discussing board business via email without including all members;
- Participating in working lunches without retaining meeting minutes;
- Considering 24 hour public notice sufficient; and,
- Making improper motions to enter executive sessions.

Per Alaska Executive Branch Ethics Act,<sup>58</sup> “a fair and open government requires that executive branch public officers conduct the public’s business in a manner that preserves the integrity of the governmental process and avoids conflicts of interest.” Furthermore, the Open Meetings Act requires actions and deliberations of executive branch employees to be conducted openly: “the peoples right to remain informed shall be protected so that they may retain control over the instruments they have created.”<sup>59</sup> The Authority’s bylaws require board and committee meetings to be held in accordance with the

<sup>58</sup>Alaska Statute 39.52.010(a)(4).

<sup>59</sup>Alaska Statute 44.62.312(a)(5).

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### Open Meetings Act.

Evidence showed that multiple trustees were, at times, intentionally trying to avoid discussing board business in a public manner. Other times, evidence showed the board simply failed to recognize the importance or need for adhering to the laws when conducting, scheduling, or noticing its meetings.

The actions of the board of trustees diminished the integrity of the governmental process by taking away the people's right to be informed. Additionally, actions taken contrary to the Open Meeting Act may be voidable and expose the board to risk of litigation.

We recommend the Authority's board of trustees and chief executive officer design and implement written procedures to ensure trustees comply with the Alaska Executive Branch Ethics Act, the Open Meetings Act, and Authority bylaws.

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# OBJECTIVES, SCOPE, AND METHODOLOGY

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In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Alaska Mental Health Trust Authority (Authority).

## Objectives

This audit responds to allegations that the Authority was not managing its assets and not conducting its business in compliance with applicable law. Specifically, the audit objectives were to:

- Determine whether Authority assets were managed as outlined in applicable laws.
- Evaluate Authority and Trust Land Office (TLO) regulations for compliance with applicable laws.
- Evaluate Alaska Mental Health Trust (Trust) asset management policies for compliance with statutes and industry best practices.
- Evaluate the use of mortgage proceeds for the acquisition of commercial real estate investments through TLO for compliance with state and federal law.
- Determine whether investment activities completed by the Authority via the TLO duplicate those carried out by the Alaska Permanent Fund Corporation (APFC) and, if applicable, whether such activities should be more appropriately or efficiently carried out by the APFC.
- Evaluate due diligence completed on the seven commercial real estate investments managed by the TLO for compliance with industry best practices.
- Evaluate whether the Authority's board and committee meetings complied with state law and corporate bylaws with specific attention to the Open Meetings Act.
- Determine whether any Authority transactions could be considered less than arm's length; encompassing TLO employees,

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Authority employees, and the Authority board of trustees.

- Review the accounting for assets managed by the TLO, including whether activity was recorded and reported in accordance with generally accepted accounting principles.
- Report on the use of Trust assets for the Icy Cape mine project.

## Scope

The audit examined:

- Authority's and TLO's operations from FY 09 through FY 17;<sup>60</sup>
- Authority board and committee meetings from FY 12 through FY 17; and
- Financial reporting of the TLO-managed assets as of June 30, 2017.

## Methodology

To address the objectives, auditors:

- Interviewed the Authority's board of trustees, the Authority's current and former senior management, and the TLO's current and former senior management as well as pertinent staff. Interviews were conducted to gain an understanding of board of trustees proceedings, Authority and TLO operations, Trust asset management practices, board and committee meeting proceedings, and possible related party relationships.
- Gained an understanding of the Authority's legal framework by reviewing the following pertinent laws and documents guiding Authority's operations:
  - Alaska Mental Health Enabling Act of 1956;
  - House Bill (HB) 201 – 18th Legislature (1993-1994) and meeting minutes documenting legislative deliberations of the bill;

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<sup>60</sup>Expenditures of cash principal on the program-related real estate were reviewed from FY 07 through FY 17.

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- Trust statutes – AS 37.14.001 – 099;
  - Authority statutes and regulations – AS 47.30.010 – 190 and 20 AAC 40, respectively;
  - TLO statutes and regulations – AS 38.05.801 and 11 AAC 99, respectively;
  - *State v. Weiss* (Alaska 1985) settlement-related documents including the 1994 *Settlement Agreement, Memorandum Decision and Order Granting Final Approval to the HB 201*, and the *Dismissal Order*;
  - *Weiss v. State* (Alaska 1997) Supreme Court opinion;
  - Civil Rule 60(b)(6);
  - Memorandum of Understanding between the Authority and Department of Natural Resources (DNR) dated June 8, 2005;
  - Memorandum of Agreement between the Authority and APFC dated July 1, 1995;
  - Open Meetings Act (AS 44.62.310 – 319);
  - Alaska Executive Branch Ethics Act (AS 39.52);
  - *Robert’s Rules of Order* (10th edition);
  - Authority’s Bylaws approved and adopted on May 7, 2014, and October 27, 2017;
  - Uniform Prudent Investor Act (AS 13.36.225 – 290);
  - Uniform Prudent Management of Institutional Funds Act (AS 13.65.010 – 095); and
  - *Principles of State Trust Portfolio Management* published by Western States Land Commissioners Association.
- Contracted with a legal firm to provide legal analysis related to the asset management audit objectives.
  - Contracted with an investment consultant to:
    - Evaluate the Authority’s asset management policies, including the Asset Management Policy Statement or AMPS (2009, 2011, and 2015 editions), the Long Term Asset Management Strategy (2003); and the Resource Management Strategy or RMS (2013, 2015, and 2016 editions), for compliance with best practices and State statutes.

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- Evaluate whether the decision of the Authority board of trustees to invest in commercial real estate through the TLO followed best practices from the perspective of an institutional investor of a state land trust.
  - Determine whether the real estate investment activities completed through the TLO at the direction of the Authority's board of trustees duplicate the directly owned real estate investments by the APFC and, if applicable, whether such activities of the TLO should be more appropriately or efficiently carried out by the APFC.
  - Determine whether the due diligence completed by TLO on seven commercial real estate investment transactions generally followed the best practices for institutional investors managing state land trusts.
  - Using the state accounting system, retrieved and evaluated Authority financial information to identify the uses of principal funds.
  - Reviewed the reimbursable service agreements between the Authority and the TLO effective from FY 09 through FY 17 to gain an understanding of the projects and expenditures incurred by the TLO for the management of Trust resources.
  - Using Authority's audited financial statements, calculated the increase in commercial real estate investments held by the Trust through the APFC and TLO from FY 11 through FY 17.
  - Reviewed and scheduled 175 board and committee meeting minutes and attended several board of trustee meetings held during the audit period to determine if conduct of these meetings complied with applicable state laws and bylaws. The meeting minutes were also reviewed to gain an understanding of the board's decision-making in relation to the commercial real estate investments and Icy Cape.

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- Using the State's Online Public Notices system, reviewed public notices of the board meeting to identify the meetings advertised for less than 24 hours.
  - Using Ingens website (<https://www.ingens.com>),<sup>61</sup> reviewed business and professional affiliations of trustees who served on the board from FY 09 through FY 17 and key Authority and TLO employees to identify related businesses.
  - Requested and reviewed ethics forms for outside employment reported by the Authority and TLO employees.
  - Reviewed TLO and select Authority employees' resumes to gain an understanding of the professional experience and to identify potential related parties.
  - Sent confirmation letters to current and former board of trustees, as well as current and former Authority and TLO employees to request disclosure of less than arm's length transactions.
  - Reviewed public email records to gain an understanding of interactions between board members and personnel and for evidence of potential conflict of interest or undisclosed business affiliations.
  - In regards to the seven commercial real estate investments managed by the TLO, reviewed the names of property management companies, lending institutions, real estate brokers, and entities involved in the due diligence analysis to determine if any of the entities are related to the board, Authority employees, or TLO employees.
  - Reviewed general ledgers maintained by property management companies for the commercial real estate investments managed by the TLO for the period of FY 12 through FY 17 to identify less than arm's length transactions.

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<sup>61</sup>Ingens is a portal that allows the search of Alaska public information.

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- Sent inquiries to the U.S. Equal Employment Opportunity Commission, the DNR Commissioner's Office, Office of the Governor, Authority's management, and the Alaska Office of the Ombudsman to identify any complaints and investigations against the Authority board of trustees and Authority and TLO employees.
  - Reviewed the procurement procedures followed by the TLO in the acquisition and management of commercial real estate investment properties to evaluate compliance with the State Procurement Code.
  - Reviewed Authority and TLO annual reports, budgets, performance measures, and newspaper articles to gain an understanding of the Authority and TLO activities.
  - Reviewed audit opinions and findings provided by the external auditor of the Authority's financial statements for FY 09 through FY 17 to determine if the statements were issued in accordance with generally accepted accounting principles. Additionally, reviewed financial records of the Limited Liability Companies, appraisals and broker's opinions of value for the seven commercial real estate investments managed by the TLO to determine the fair market value of the properties and associated mortgage amounts as of June 30, 2017.
  - Reviewed asset management studies sponsored by the Authority's management including the reports by Callan (published in 2006, 2008, and 2011) and Meketa (2017).
  - Requested and reviewed written explanations from the Authority board chair and DNR commissioner in regards to audit-related matters.
  - Inquired with the APFC management to determine the possible treatment of the commercial real estate investments acquired to date by the Authority through the TLO.

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# APPENDICES

## SUMMARY

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**Appendix A** provides a summary of governing principles for board operations and trust investments that were used as audit criteria.

**Appendix B** provides a complete copy of the independent investment consultant report titled *Review of Alaska Mental Health Trust Authority Policies and Real Estate Transactions* by RVK, Inc. RVK, Inc. was retained by the Division of Legislative Audit to conduct a review of the Trust asset management policies and objectives in effect from FY 09 through FY 17 for compliance with applicable laws and industry best practices.

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# APPENDIX A

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## Governing Principles for Board Operations and Trust Investments

### Board Operations

The Alaska Mental Health Trust Authority's (Authority) board of trustees operate in accordance with bylaws outlining rules for the organization. The major components of the bylaws include the purpose of the organization; board of trustee membership, terms of office, and duties; officers' duties; board and committee meetings; and description of committees. In accordance with the bylaws, meetings of the board and its committees are subject to the Open Meetings Act and the proceedings are governed by the *Robert's Rules of Order*. Additionally, the Authority members are required to comply with the Alaska Executive Branch Ethics Act.

The Open Meetings Act<sup>1</sup> requires that all meetings of the board of trustees and its committees be open to the public and that the body provide reasonable notice of its meetings. Alaska Statute 44.62.310(h)(2) defines the term "meeting" as a gathering of members of a governmental body when:

*(A) more than three members or a majority of the members, whichever is less, are present, a matter upon which the governmental body is empowered to act is considered by the members collectively, and the governmental body has the authority to establish policies or make decisions for a public entity; or*

*(B) more than three members or a majority of the members, whichever is less, are present, the gathering is prearranged for the purpose of considering a matter upon which the governmental body is empowered to act, and the governmental body has only authority to advise or make recommendations for a public entity but has no authority to establish policies or make decisions for the public entity.*

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<sup>1</sup>Alaska Statute 44.62.310 and 44.62.312.

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## APPENDIX A (Continued)

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The Open Meetings Act is intended to ensure that actions and deliberations are conducted by governmental entities openly and that the people's right to remain informed is protected. In order to protect the public's right to know, the act requires that:

- all deliberations and action taken by a public entity be done in public view, with specific limited exceptions;
- the public be provided prior knowledge of all steps occurring in the decision making process, with limited exceptions;
- individual actions of an official are made known;
- a motion to convene an executive session clearly and with specificity describe the subject (see Exhibit A) of the proposed executive session; and that
- no action may be taken at an executive session, except to give direction to an attorney or labor negotiator regarding a specific matter.

### Exhibit A

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#### Subjects Considered in Executive Session (AS 44.62.310)

1. Matters that could adversely affect the finances of the public entity.
  2. Subjects that tend to prejudice the reputation and character of any person.
  3. Matters required to be confidential.
  4. Matters considering records that by law are not subject to public disclosure.
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Source: DCCED management.

In order for these requirements to have full effect, meetings must occur as provided in the notice, and, with few exceptions, the public must be allowed to involve itself in the meeting. The public must also have access to materials being considered during the meeting.

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## APPENDIX A (Continued)

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*Robert's Rules of Order* embodies a codification of the present-day general parliamentary law to be adopted by organizations. Once adopted, the requirements are binding upon an organization and constitute that organization's rules of order. The rules are constructed based on the regard for the rights of the majority, the minority, individual members, absentees and all of these together. One of the underlying principles of the *Robert's Rules of Order* is that during the proceedings each individual or subgroup has the right to express his or her position to the decision making majority. The records of the proceedings are called minutes and should be retained for all meetings.<sup>2</sup>

The Alaska Executive Branch Ethics Act (AS 39.52) outlines ethical expectations and responsibilities for current and former executive branch employees and members of statutorily created boards and commissions. The Ethics Act requires certain disclosures for:

- Any matter that is a potential conflict of interest with actions that the member may take when serving on the board or commission.
- Any circumstance that may result in a violation of the Ethics Act.
- Any personal or financial interest (or that of an immediate family member) in a state grant, contract, lease or loan that is awarded or administered by the member's board or commission.
- The receipt of certain gifts.

The Authority does not have policies to interpret the requirements of the Alaska Executive Branch Ethics Act. However, Ethics Act Procedures for Boards and Commissions published by the Department of Law provides guidance to State boards and states, "Members must declare potential conflicts and other matters that may violate the Ethics Act on the public record and in writing to the chair."

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<sup>2</sup>10th edition, Chapter XV, §48.

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## APPENDIX A (Continued)

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### Trust Investment Principles

Guiding principles for Trust investment are included in the Uniform Prudent Investor Act, Uniform Prudent Management of Institutional Funds Act, and Western States Land Commissioners Association's best practices document *Principles of State Trust Portfolio Management*. Each of these principles is discussed below.

- **Uniform Prudent Investor Act (UPIA)** is a law that sets out the framework within which trustees must invest and manage trust assets. The UPIA provides rules that result in greater protection of the trust's assets and offer a prospect of better income by requiring careful assessment of investment goals, analysis of risk versus return, and diversification of assets to protect them. Per this act, the standard of prudence should be applied to any investment in the context of the portfolio as a whole, rather than to individual investments. The Act was adopted by the State of Alaska in 1998 (codified in AS 13.36.225 – 290).
- **Uniform Prudent Management of Institutional Funds Act (UPMIFA)** provides uniform and fundamental rules for the investment of institutional funds held for charitable purposes<sup>3</sup> and the expenditure of funds donated as endowments to those institutions. The UPMIFA requires investment “in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.” The act also requires prudence in incurring investment costs, authorizing “only costs that are appropriate and reasonable.” The UPMIFA emphasizes that investment decisions must be made in relation to the overall resources of the institution and its charitable purposes. No investment decision may be made in isolation, but must be made in light of the fund's entire portfolio, and as a part of an investment strategy “having risk and return objectives reasonably suited to the fund and to the institution.” Assets must be reviewed within a reasonable time after they come into the possession of the institution in order to conform them to the investment strategy

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<sup>3</sup>Charitable purpose includes the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or another purpose the achievement of which is beneficial to the community.

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## APPENDIX A (Continued)

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and objectives of the fund. Investment experts, whether in-house or hired for the purpose, are held to a standard of care consistent with that expertise. The State of Alaska enacted UPMIFA in 2010 (codified in AS 13.65.010 – 095).

- **Principles of State Trust Portfolio Management** is the best practices document created in 2016 by Western States Land Commissioners Association for use by state entities responsible for management of trust lands. According to this document, State trusts exist to provide perpetual benefit for trust beneficiaries and must provide for intergenerational equity, with intergenerational equity being a core guiding principle for state trust management. Furthermore, best practices provide that trust managers should establish portfolio goals that help drive investment decision making and guide changes to the portfolio allocation over time. Portfolio goals should be deliberate, reasonable and prudent. Portfolio goals should include moving toward a diversified asset allocation and a sustainable rate of return in excess of inflation in order to support all generations of beneficiaries. Land, minerals, buildings, and financial assets are components of a single portfolio, and, to the extent possible, should be managed as a single portfolio.

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## Review of Alaska Mental Health Trust Authority Policies and Real Estate Transactions

Alaska Division of Legislative Audit

January 2018



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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



### Table of Contents

	Page
Overview and RVK Project Team .....	3
Evaluation of AMHTA Investment Policies and Objectives .....	9
Evaluation of AMHTA Real Estate Transactions via Trust Land Office .....	14
Evaluation of Specific Real Estate Transaction Due Diligence .....	20
Concluding Thoughts .....	29

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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



### Overview

RVK, Inc. ("RVK") was retained by the Alaska Division of Legislative Audit to conduct a review of the Alaska Mental Health Trust Authority ("AMHTA") investment policies and objectives in effect from fiscal year 2009 through fiscal year 2017 for compliance with generally accepted industry best practices. Additionally, RVK's scope of work encompassed an evaluation of whether or not the decision of the AMHTA's Board to invest in commercial real estate through the Trust Land Office ("TLO") followed best practices from the perspective of an institutional investor. This report details RVK's observations in the following areas of review:

- Evaluation of AMHTA investment policies and objectives for compliance with best practices, from the perspective of an institutional investor, with an emphasis on state land trusts. Evaluation of policies and objectives against best practices, as well as areas for improvement, considered the following: Uniform Prudent Management of Institutional Funds Act, Alaska Uniform Prudent Investor Act, Western States Land Commissioners Association's Principles of State Trust Portfolio Management, and other widely observed best practices applicable to the institutional investors of state land trusts.
- Evaluation of the decision of the AMHTA's Board to invest in commercial real estate through the TLO relative to best practices from the perspective of an institutional investor of a state land trust.
- Evaluation of seven specific real estate transactions made by the TLO, at the direction of the AMHTA Board. Consideration was given to potential duplication of the directly owned real estate investment objectives of the Alaska Permanent Fund Corporation ("APFC") and, whether or not such activities of the TLO should be more appropriately or efficiently carried out by the APFC. This evaluation included a general comparison of available TLO investment resources relative to the APFC investment resources focused on commercial real estate investments.
- Determination of whether the overall process and due diligence protocols applied by TLO for seven specific real estate investment transactions generally followed best practices.

All "best practices" referenced in this report refer to RVK's best professional judgment as to the policies and procedures that constitute prudent and competent institutional fund investing. No formal comprehensive list of best practices exists to cover all aspects and all circumstances faced by institutional investors. There are, however, many sources from which guidance as to what constitutes "best practice" can be drawn and our firm and team are familiar with the standards advocated by current academic, practitioner, educational, as well as regulatory and statutory authorities ranging from the Chartered Financial Analyst Institute (officially the "CFA Institute") to

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



the Employee Retirement Income Security Act (“ERISA”), as well as the sources more specific to the investment of special purpose funds such as that of the AMHTA. Also note that the specific circumstances surrounding the investment decisions required may raise the importance of some of these broadly accepted best practices while diminishing the importance of others.

### **RVK Project Team**

RVK constructed a project team composed of the below professionals.



**Jim Voytko – President, Director of Research, Senior Consultant, Principal**

Located in our Portland office, Jim serves as President, Director of Research, and as a Senior Consultant with RVK. He joined the firm in 2004 and has over 35 years of industry experience.

Prior to joining RVK, Jim served as the CEO/Executive Director of Oregon’s statewide pension system for all employees of state and local governments, police and fire, teachers and higher education, statewide retiree health care insurance program, and statewide 457 deferred compensation program. He also served on the five-member Oregon Investment Committee, which directed the investment of all statewide funds totaling approximately \$45 billion.

Jim’s experience also includes serving as Director of Research for Paine Webber, CIO and Managing Director of PNC Asset Management Group/PNC Advisors, and the Deputy Director and Chief Operating Officer of PaineWebber’s Investment Banking Division. Notably, of the various roles that Jim has served, he has experience conducting due diligence and collaborating with internal audit professionals, external auditors, and most relevant, statutorily mandated audit professionals (from both the executive and legislative branches of state government).

Jim earned his Bachelor of Arts degree from Carnegie Mellon University, a Master of Public Administration degree from the University of Washington, and Master of Public Policy degree from Harvard University. Jim is a shareholder of the firm and serves on the firm’s Board of Directors.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



### **Jennifer Sandberg – Consultant**

Jennifer joined RVK in 2006 and is located in our Chicago office. She has held a number of roles at RVK, including Investment Analyst, Investment Associate, and Associate Consultant. In 2017, she was promoted to Consultant.

Jennifer works closely with clients and consulting teams on all aspects of a consulting relationship, including asset allocation and policy setting, investment manager research and due diligence, forward-looking capital market assumptions, and asset class portfolio structuring. She is also a member of RVK's outsourced

CIO (OCIO) search and monitoring team, assisting clients who wish to engage with a discretionary provider.

Jennifer recently completed a challenging project where she led an RVK team (retained by a corporate fiduciary committee) to review a key provider of investment management services that was also a subsidiary of the parent corporation. Jennifer earned a Bachelor of Business Administration degree in Finance from Western Michigan University.



### **Kim Cash, CFA, CPA, CAIA, CIPM – CCO/IOSG Consultant**

Kim joined RVK's Portland office in 2015 as a Consultant in our Investment Operations Solutions Group, leading operational due diligence research on hedge fund providers and conducting investment operations vendor evaluations and searches. She has over 20 years of investment risk management and consulting experience. Kim holds the CFA Charterholder, CPA, CAIA, and Certified Securities Compliance Professional (CSCP) designations as well as having a Certificate in Investment Performance Measurement.

Prior to joining RVK, Kim was with an internationally-recognized CPA firm for over 19 years, specializing in internal control, compliance and performance consulting, SSAE 16 examinations, and GIPS verifications exclusively for financial services organizations. Kim graduated from California State University, Fresno, with a Bachelor of Arts degree and also has a Master's degree in Education from Concordia University, Portland.

The project team was advised by RVK Investment Manager Research professionals.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



**Sean Ealy, CFA – Director of Investment Manager Research, Principal**

Sean joined RVK in 1995 and is located in our Portland office. He serves as the Director of Investment Manager Research, where he leads the team of Research Consultants who study each asset class and determine the most appropriate managers for each client assignment, as well as the efficacy of firms currently managing assets for clients.

Sean earned his Bachelor of Business Administration degree from the University of Oregon and a Master of Business Administration degree from Portland State University. Sean is a member of the CFA Institute and the CFA Society of Portland. Sean is a shareholder of the firm and currently serves on the firm's Board of Directors.



**Steven Hahn, CFA – Director of Alternatives, Principal**

Steve joined RVK in 2007 and is located in our Portland office. He is a senior member of the Investment Manager Research team and leads research in multiple alternatives asset classes, including private equity, multi strategy hedge funds, real assets, real return and various tactical allocation strategies.

Prior to joining RVK, Steve held a variety of investment management positions, including work with the alternatives portfolio at the University of Colorado Foundation. He also worked with a Private Equity fund of funds where he was responsible for conducting qualitative and quantitative due diligence, sourcing potential partnership investments, and developing cash planning models for several large state pension funds. Steve's previous experience also includes working as an equity analyst.

A graduate of the University of Colorado with a Bachelor of Science degree in Business Administration with a Finance concentration, Steve holds the Chartered Financial Analyst designation.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



**Austin Head-Jones, CFA, CQF – Manager Research Consultant**

Austin joined RVK in 2017 as a Manager Research Consultant and is located in our Portland office. She is a member of our Investment Manager Research team and contributes to the alternatives research team’s efforts on alternative investment strategies.

Prior to RVK, she worked as an Associate Director for PAAMCO in Irvine, CA, researching hedge funds, and most recently worked with Pension Consulting Alliance on several projects related to their Crisis Risk Offset (CRO) offerings.

Austin has an MBA with honors from the University of Chicago, Booth School of Business. She also graduated *magna cum laude* from Brown University with a BA, majoring in international relations. Austin is a CFA charterholder and has received her Certificate in Quantitative Finance (CQF).



**Joseph Delaney, CAIA, FRM – Manager Research Consultant**

Joseph (“Joe”) joined RVK in 2015 as a Senior Manager Research Analyst and is based in our Portland office. In 2017, he was promoted to Manager Research Consultant. Joe leads the firm’s research and due diligence efforts on Real Estate within our Alternative Assets team. Prior to assuming Real Estate coverage at RVK, his responsibilities as a Generalist included: manager evaluation, conducting due diligence, working closely with clients on manager search activities and general market structure projects.

Joe has nearly 20 years of investment experience, spanning buy-side institutional asset managers, most recently in portfolio management and trading at PIMCO. Prior to PIMCO, he worked at STW Fixed Income Management (Schroder Investment Management) for several years. Over his career, he has held senior roles in operations, performance measurement, legal & compliance, and trade flow management.

**RVK Approach and Methods for Review**

RVK received and reviewed documents relating to all aspects of this project, including the AMHTA Asset Management Policy Statement, TLO Resource Management Strategy, and Program

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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



Related Investment plan. We compared the policy, strategy, and operational documents of the AMHTA and the TLO to broadly accepted best practices observed in institutional investing. We did not independently audit or verify any information provided to us through the Legislative Audit staff and relied upon it in our work as received.

**Review of Policies:** RVK reviewed and analyzed the AMHTA's policy documents provided by the Division of Legislative Audit, including the Asset Management Policy Statement, the TLO Resource Management Strategy, the Program Related Investments plan, the respective AMHTA resolutions, and the summary of laws and policies regarding use of TLO proceeds. RVK leveraged the team's expertise and knowledge of the Uniform Prudent Management of Institutional Funds Act, Alaska Uniform Prudent Investor Act, Western States Land Commissioners Association's Principles of State Land Trust Portfolio Management, and our firm's 30+ years of experience providing investment consulting advice to institutional fund fiduciaries to evaluate the AMHTA's policies relative to best practices.

**Review of Specific Real Estate Transaction Due Diligence:** RVK reviewed the due diligence documentation provided by the Division of Legislative Audit on seven specific real estate transactions executed by the TLO between fiscal year 2011 and fiscal year 2017. RVK Manager Research leveraged the depth and breadth of experience evaluating real estate managers, strategies, and transactions to evaluate whether the specific transactions followed due diligence best practices. Additionally, we offer an investment review and due diligence checklist derived by RVK's research professionals supplemented by information provided by professional real estate managers on key categories relevant to best practices. This due diligence checklist leverages RVK's expertise in evaluating real estate managers and transactions across a wide array of strategies and styles. An important caveat: due diligence processes are far from uniform across institutional investing and the concept of "institutional due diligence best practices" varies from investor to investor.

**Review of Real Estate Resources:** RVK reviewed the biographies of TLO staff focused on real estate investing and participated in conference calls with the Division of Legislative Audit to discuss technology, human capital, and third party resources available to the TLO. Additionally, RVK concurrently reviewed the resources available to the APFC to offer a broad comparison of expertise between the two organizations managing assets for the AMHTA.

RVK was charged to use our 32 years of experience in consulting to institutional investment funds, our experience with broadly accepted best practices in institutional investing, and our staff expertise to address each of these issues. Through our review and analysis of materials provided, RVK directly addresses each aspect of the project scope on the pages that follow.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



### Evaluation of AMHTA Investment Policies and Objectives

RVK reviewed the AMHTA Asset Management Policy Statement (“AMPS”) provided by the Division of Legislative Audit, revised on three occasions from 2009 through 2015. The purpose of the AMPS is to delineate the asset management philosophy and practices of the Board of trustees of the Alaska Mental Health Trust Authority. The document serves as the management plan for those assets, both cash and non-cash, entrusted to the Board. The stated purpose of the AMPS is:

- 1) to communicate objectives, goals, and restrictions with regard to the management of Trust assets,
- 2) that assets be structured and managed in a prudent manner, and
- 3) to provide a meaningful basis for performance evaluations of asset classes, managers and strategies.

RVK believes the AMPS falls short of a best practice policy statement when viewed through the lens of an institutional investor with a focus on state land trusts. Additional detail is offered in the following paragraphs but in summary, the AMPS lacks an entity-wide view of the AMHTA assets, both cash and non-cash. The policy fails to outline the objectives of the aggregate assets, including a stated asset allocation strategy, risk tolerance, and monitoring guidelines incorporating both cash assets (managed by the APFC) and non-cash assets (land assets managed by the Trust Land Office). The AMPS’s lack of entity-wide view of the AMHTA assets challenges the Board’s ability to fulfill its fiduciary responsibility in aggregate oversight, cost control, and prudent diversification of all Trust assets.

RVK has identified the below areas for improvement within the AMPS. In carrying out its stated purpose and fiduciary responsibilities, the AMPS should seek to:

1. Create an organizational structure whereby evaluation of cash and non-cash assets are addressed by a single fiduciary body and incorporate an entity-wide view of all AMHTA assets. Any such policy revisions should seek to remove the current organizational structure impediment of parallel evaluation committees for the cash and non-cash assets. A single fiduciary body with oversight of the AMHTA assets would allow the Board to make prudent entity-level diversification decisions. A best practice policy should view cash and non-cash assets as a single portfolio in order to apply prudence at the portfolio level and move towards a diversified asset allocation.
2. Develop and document an aggregate asset allocation policy. The AMHTA Board may delegate investment management of a portion of the AMHTA assets to each of the Alaska Permanent Fund Corporation (“APFC”) and Trust Land Office (“TLO”); however, such delegation does not remove the Board’s fiduciary responsibility for oversight of prudent

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



diversification, monitoring, performance evaluation, and cost control for the aggregate assets.

3. Document decision-making addressing the rationale for utilization of the TLO as a real estate investment program to drive revenue growth for the AMHTA. If the AMHTA seeks to have the TLO pursue real estate investing, a best practice policy should address specific guidelines in how such a program is to be carried out.

The evolution of the AMPS incorporates small wording changes to accommodate the TLO's real estate investment activities, as opposed to the policy driving such investment activities. A best practice policy should be sufficiently specific to offer fiduciaries clear guidance on roles and responsibilities for key stakeholders and allow policy documents to guide investment decisions.

- 1. Create an organizational structure whereby evaluation of cash and non-cash assets are addressed by a single fiduciary body and incorporate an entity-wide view of all AMHTA assets.**

A significant, over-arching concern is the lack of an entity-wide perspective for the AMHTA assets and a long-term asset allocation policy. Best practices established by the Uniform Prudent Management of Institutional Funds Act (UPMIFA), Alaska Uniform Prudent Investor Act, Western States Land Commissioners Association's Principles of State Trust Portfolio Management recommend the AMHTA's cash and non-cash Trust land assets be considered as a single portfolio when establishing investment policies, in order to apply prudence at the portfolio level and move toward diversified asset allocation. The Western States Land Commissioners Association's Principles of State Trust Portfolio Management states specifically that land minerals buildings and financial assets should be managed as a single portfolio.

The AMPS does address an asset management philosophy and cash and noncash objectives; however, responsibility for the cash investment guidelines and selection and supervision of investment managers is delegated to the APFC. The AMPS should clearly articulate the AMHTA's asset allocation strategy for the entire asset base, both cash and noncash assets. While the long-term asset allocation strategy of the APFC may represent an appropriate risk/return profile and align with the AMHTA investment goals and objectives, this asset allocation strategy fails to incorporate the additional real asset, land, and real estate asset exposures managed by the Trust Land Office ("TLO").

- 2. Develop and document an aggregate asset allocation policy. The AMHTA Board may delegate investment management to qualified service providers; however, such delegation does not remove the Board's fiduciary responsibility for oversight of prudent diversification, monitoring, performance evaluation, and cost control for the aggregate assets.**

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



The importance of the AMPS addressing entity-wide monitoring, risk control, and asset allocation is not simply a matter of form over content. Such an entity wide perspective is the starting place for the AMHTA to carry out its fiduciary responsibility in delivering intergenerational equity in perpetuity. UPMIFA (codified in AS 13.65) delineates several duties, including a duty to minimize costs and a duty to diversify. The APFC is evaluated by the finance committee and the TLO operates an investment program overseen by the Resource Management Committee. Given the parallel committee structure for evaluation of investment activities, it is unclear how the Board would be able to effectively make prudent cost and diversification decisions. The parallel committee structure for evaluation of investment activities creates an oversight structure that impedes the AMHTA Board's ability to review the AMHTA assets with a total portfolio view. The AMPS not addressing fiduciary responsibility at the entity level is a critical oversight in policy development and management.

The AMPS is largely silent in all three stated purposes above regarding the TLO. Guidance for the non-cash Trust land assets managed by the TLO is documented in the Resource Management Strategy ("RMS"). The AMPS references 11 AAC 99, which contains the below outlined principles pertaining to the management of trust land (emphasis added), but is completely silent as to any other guiding principles for a direct equity real estate investment program:

- (1) maximization of long-term revenue from trust land;
- (2) protection of the corpus;
- (3) protection and enhancement of the long-term productivity of trust land;
- (4) encouragement of a diversity of revenue-producing uses of trust land; and
- (5) management of trust land prudently, efficiently, and with accountability to the trust and its beneficiaries.

The lack of guidance regarding the pursuit of commercial real estate investment activities by the TLO, including fit within the broader asset portfolio, allowable or restricted investments, clearly articulated diversification guidance, and documented performance evaluation guidelines, represents significant gaps in the AMPS.

The RMS is a policy document that serves to govern Trust land assets. The RMS serves to outline the long-term asset management strategy that establishes goals for managing Trust land assets to execute the overall Trust management principles. The RMS was officially adopted in 2013 and provides guidance to the TLO for management of the Trust's non-cash asset base.

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



RVK believes the Resource Management Strategy falls short of a best practice policy document. The RMS appears to evolve over time in response to desired real estate investment activities rather than the policy statement driving decision-making for the AMHTA Board and TLO Staff. A best practice strategy or policy should provide fiduciaries with clear guidelines on investment objectives, performance goals, diversification, and how to evaluate investments against such goals. Investment decision-making should be guided by the principles outlined in the policy document, not vice-versa.

When looking to the RMS for guidance in managing Trust Land assets, the RMS fails to consider the total Trust exposure to real estate via cash and non-cash assets (specifically real estate investments already managed as part of the cash portion of the portfolio with the APFC). Additionally, there is no indication of why, where, when or the size of investments to be made—or not made—in the lower 48. Specific to location of real estate assets, for example, in the 2013 TLO Resource Management Strategy, the asset location policy states that,

*“To minimize concentration of risk, The Trust should consider the location of its assets as a whole. Investing in a variety of real estate markets will protect Trust assets from the fluctuations of a particular market.”*

In the 2016 TLO Resource Management Strategy, the asset location policy states that,

*“Over-concentrating investment in one location or local economy is to be avoided. This is to minimize the effects of impacts from factors outside the Trust’s control, such as an economic downturn or an oversupply of property type. There are also practical limits on the number of separate markets that a small staff can adequately manage.”*

The above RMS quotes highlight that policy language falls short of best practice standards given the language offers fiduciaries no clear guidance on what constitutes sufficient diversification. These statements lack clarity defining diversification by geography and sector/economically sensitive market segments (e.g. property type and geographic exposure).

RMS language appears to shift over time to encompass the pursuit of real estate investment activities, as opposed to simply addressing the stated goal of diversification of revenue sources from Trust land. Additionally, the final sentence from the second quoted section above notes the potential challenges a staff of small size faces in managing an asset portfolio spanning a number of separate markets.

Specific to the size of investments to be made, the asset allocation criteria in the RMS from 2013 to 2015 targeted a \$40 million equity investment, which would be combined with a targeted \$40-80 million in debt. In 2016, however, invested equity dollars approached the \$40 million target allocation and the RMS asset allocation criteria language removed mention of a targeted equity

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



investment and instead stated, “The principal investments in income property will be determined by trustees on a case-by-case basis.” Such a change may indicate real estate investment activities driving policy revisions, rather than the RMS guiding the appropriateness of additional investments for the portfolio. Additionally, the RMS is silent regarding the size of the Trust’s real estate investments managed by the APFC. A lack of entity-wide view is a critical oversight in policy development as noted on the previous page.

In 2015, three years after the adoption of the RMS, the AMPS was revised to incorporate a paragraph addressing “Performance Expectations” specific to the TLO’s real estate investment activities, “The performance of direct private equity real estate will be annually evaluated using an index or indices determined by the resource management committee.” However, the RMS offers no stated benchmark against which real estate investments are to be evaluated and in reviewing the TLO Annual Report for each fiscal year 2013 through 2016, no indices were provided for performance evaluation. Additionally, the 7.5% hurdle rate stated in 2013 was revised in 2016 to state “a hurdle return rate for investment will vary based on the needs of the Trust and the Permanent Fund’s projected 10 year return.”

The RMS also states that, for purposes of evaluating the success of the investment plan, the primary measurement should be the cash-on-cash percent of return because of “the income nature of the investment returns.” This runs contrary to WSLCA guidance and CFA Institute guidance that portfolio performance should be measured on a total-return basis, considering both capital appreciation and income. Given the illiquid nature of real estate, the CFA Institute has established comprehensive best practice disclosure guidance specific to real estate reporting. This guidance includes requiring since-inception internal rates of return (“IRR”) be presented through each annual period end, along with a since-inception IRR for a benchmark that must reflect the investment mandate, objective, or strategy and be presented for the same time period. Although developing a meaningful benchmark for illiquid investments provides an added layer of complexity, as part of prudent investment best practices, benchmarks remain a critical reference point for analyzing the risk and return of an investment with greater meaning than an investment evaluated in isolation. A best practice policy should offer fiduciaries clearly stated benchmarks against which investment activities are to be evaluated.

Another disclosure/performance monitoring best practice area where the TLO’s policy document is silent is the frequency of ongoing external valuations on the properties to facilitate prudent monitoring. The CFA Institute highlights the best practice use of an independent third party for asset valuations to ensure inputs are reasonable to determine fair market value. The small internal staff at the TLO further necessitates documentation for the use, and frequency, of an appropriately credentialed third party for external valuations.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



In addition to best practice guidance for real estate performance reporting, the CFA Institute has also published best practice guidance for asset owners, which requires net of fees returns that reflect all costs of management of the assets. In addition to all investment management costs, such costs “may also involve a pro rata share of overhead and other related costs and fees, including data valuation fees, investment research services, custodian fees, pro rata share of overhead (such as building and utilities), allocation of non-investment department expenses (such as human resources, communications, and technology), and performance measurement and compliance services.” RVK did not find any such guidance on performance measurement and addressing associated costs presented in the RMS. Additionally, RVK found no performance information presented on the TLO investments in any materials provided for our review.

- 3. Document decision-making addressing the rationale for utilization of the TLO as a real estate investment program to drive revenue growth for the AMHTA. If the AMHTA seeks to have the TLO pursue real estate investing, a best practice policy should address specific guidelines in how such a program is to be carried out.**

Based on information provided, one of the objectives of the AMHTA is to increase income generated by the Trust; however, AMHTA income needs alone do not constitute a prudent investment rationale for using the TLO to drive direct real estate exposure over other options. Use of the TLO and the creation of a national direct commercial real estate investment program may well produce additional revenue generation; however, discussion and documentation of that fundamental decision and the rationale for it set forward in a comprehensive fashion is a critical gap in the AMPS.

If the TLO is to continue with its real estate investment activities, the AMPS needs to address investment objectives and guidelines for how such assets can be prudently structured, managed, and evaluated.

### **Evaluation of AMHTA Real Estate Transactions via Trust Land Office**

#### **Assessment of Real Estate Investment Activities by TLO vs. Objectives of APFC Real Estate Strategy**

RVK was tasked with evaluating whether or not real estate investment activities made by the TLO, at the direction of the AMHTA Board, duplicate the real estate investment objectives of the APFC and, if applicable, whether such activities should be more appropriately or efficiently carried out by the APFC. During our evaluation and analysis, in addition to the TLO RMS, RVK reviewed the real estate guidelines section of the APFC Investment Policy Statement, the APFC Real Estate Investment Strategy, current APFC real estate portfolio investments, and the resources (internal and external) available to the APFC in pursuit of policy objectives.

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



RVK believes the decision by the AMHTA Board to invest in commercial real estate via the Trust Land Office does not constitute best practice and would recommend the APFC execute real estate investment activities. Delegation of real estate investment activities to the APFC would serve the AMHTA well from a risk mitigation standpoint. The TLO portfolio lacks, and may be challenged to achieve, a prudent level of diversification at their asset size. The TLO demonstrates acceptable due diligence researching and buying properties; however, the APFC offers deeper resources and a strong advisor network, and the team is better equipped to manage an institutional quality real estate portfolio. RVK does not view the TLO as the prudent, diversified, and cost effective approach to pursuing real estate investment activities and believes Trust assets in commercial real estate are more appropriately invested by the APFC.

The APFC Investment Policy Statement seeks to set out the Board's policies and practices regarding investment-related functions. The APFC Investment Policy Statement outlines objectives for the real estate portion of the APFC portfolio. Within the APFC Investment Policy Statement, the real estate investment strategy is referenced. The real estate investment strategy is prepared by Staff and sets out APFC's three- to five-year objectives and implementation plan for investment and management of the Fund's real estate assets. The purpose of the APFC real estate investment strategy document is to, "define the current strategy approved by the Board for real estate so that all contributing members: investment managers, consultant, and APFC staff are clear in their roles."

At the highest, most conceptual level, the principles outlined in the TLO Resource Management Strategy for investment in commercial real estate overlap with those documented in the APFC Real Estate Investment Strategy. The TLO Resource Management Strategy offers broad, arguably vague, guidance to fiduciaries on permissible investments, risk guidelines and controls, portfolio growth and performance objectives, and lacks quantifiable benchmarks for evaluation of progress toward the achievement of these objectives.

The APFC documents, in contrast, contain specific performance objectives, risk and diversification tolerances, and long-term objectives of the real estate portfolio within the APFC.

Internal staff resources (team size, industry experience, backgrounds, etc.) during the evaluation period, were not identical, but of similar depth across the two organizations. However, RVK believes that the depth of APFC's commercial real estate advisor relationships appear superior to the TLO's in several aspects which we observe are often critical to the sustained long-term performance of a successful commercial real estate investment program. These critical capabilities include deal sourcing, a far-reaching information pipeline, and access to additional human capital (i.e., real estate investing expertise).

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



The APFC also monitors portfolio-level exposures through Yardi Yoyager, an integrated web-based platform. TLO staff track and monitor real estate investment activities via manual electronic file storage processes and spreadsheets.

### **Duplication of Exposures**

RVK reviewed the property-level exposures of the APFC real estate portfolio provided by the Division of Legislative Audit. We note no specific property duplication exists between the TLO and APFC portfolios. RVK does note, however, the relatively high concentration of property exposures in Texas. Additionally, the concentration of property investments in the TLO portfolio, geographically in the West and South and of the office property type, present the potential for overlapping market-specific exposures thereby potentially reducing diversification and thus potentially introducing unnecessary risk to long-term returns.

### **Comparison of Real Estate Investment Resources**

The TLO and the APFC organizations invest a very different scale of capital in directly owned real estate properties: TLO invests \$98 million across just seven real estate properties, while the APFC invests over \$4.1 billion across 55 directly held properties. The APFC also has approximately \$1.4 billion invested in Simpson Housing LLLP, a real estate operating company that owns and operates large multi-family properties across the U.S., and is jointly owned with another institutional investor. The size and breadth of the APFC's real estate program is, in our experience, more likely to lead to a superior level and quality of information flow from commercial real estate market participants.

The internal investment teams focused on real estate due diligence and investments at TLO and APFC are similar in size. For the evaluation period, the TLO employed three individuals. We would note that since the evaluation period, the staffing level has been reduced to one due to the departures of Mr. Morrison and Mr. Yackel. The APFC employs a team of four. APFC's staff has a much longer tenure in total, but TLO's staff during the evaluation period had reasonable experience prior to joining the organization. However, the APFC's superior access to third party advisors to source and conduct diligence on properties is a significant resource. The TLO also receives assistance in diligence efforts from third party providers; however, the TLO does not utilize these resources at the same scale as APFC.

### **TLO Real Estate Investment Capabilities**

TLO employed a staff of three individuals to manage real estate investments internally during the evaluation period for this report. The table below indicates their names, title and experience.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



Name	Title	Years of Industry Experience	Years with TLO
Bryan Yackel	Asset Manager	13	3 (Left TLO in July of 2017)
Craig Driver	Asset Manager	21	3
John Morrison	Executive Director of Trust Land Office	12	6 (Left TLO in September of 2017)

Staff's ranges of experience prior to joining TLO include commercial property development, acquisitions, sales, leasing and legal representation related to real estate activities. The individuals' experience appears to be relevant for a team charged with investing in real estate opportunities.

In addition to the individuals mentioned above, TLO has additional staff responsible for management of lands, minerals, and other assets of the organization. These categories of staff include 16 individuals as well as two open positions listed, as indicated by their website. While a broad organizational resource, this additional personnel is predominantly focused on land management.

Staff also leverages third party providers to assist in their diligence effort. This includes appraisers, legal counsel, environmental engineers, and other providers necessary for specialty assessments.

Staff broadly summarized the steps of their due diligence process as follows:

- **Appraisal** – is performed by a Certified Real Estate Appraiser with any acquisition as part of the REMP plan.
- **ALTA Survey** – is a specific kind of survey that goes beyond locating the parcel and any structures. The ALTA Survey also notes any items related to title such as trespass and easements. ALTA surveys are also performed to a more exacting standard.
- **Title Review** – is performed early in the due diligence period by an attorney to ensure that the seller has the rights to the property they have presented.

## APPENDIX B (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



- **Phase 1 Environmental** – is a review of the structures, grounds, and all the business processes performed there in. It is performed by an environmental engineer and provides information as to the possible presence of contaminants.
- **ADA inspection** – ensures that the building is up to proper code with regard to the Americans with Disabilities Act.
- **Structural Inspection** – provides an analysis of the structure as a whole as to the suitability of its current use, and an estimate of useful life.
- **Geotechnical Inspection** – specifically inspects the structure to ensure it meets seismic standards.
- **Roof Inspection** – provides a report on the condition and useful life of the roof. In addition, it will recommend a maintenance schedule to maximize the useful life.
- **HVAC Inspection** – provides a report on the condition and useful life of the HVAC system. In addition, it will recommend a maintenance schedule to maximize the useful life.
- **Capital Project Review** – is an analysis of projects performed over the life of the building so that any of the other inspections may pay close attention to the subject area. It is also used as part of the financial analysis to determine the capital budget.
- **Financial Review** – is an analysis of the operations of the property for the last several years to determine if they are as presented in the sale.
- **Tenant Communications** – the TLO will continue communications with the tenants to discuss their use and plans for the facility.
- **Vetting of Seller** – the overall analysis that the seller has the authority to sell their interest in the property as negotiated.

*The TLO will amass and study all the information produced as well as make physical inspections of the property.*

*The information will be taken as a whole to determine if the transaction will be completed. If a concern is uncovered during the process there are various ways to negotiate and mitigate the effects. If a concern is found that is unacceptable to the TLO, the transaction may be cancelled at any time before the end of the due diligence period without penalty.*

The diligence process as outlined appears potentially adequate at the asset level in combination with due diligence efforts performed by various third party vendors. These two combined efforts have the potential to meet reasonable expectations, in RVK's view, for best practices with regard to asset level due diligence. However, this process appears to lack diligence around the potential impact of acquired assets at the portfolio level, which we address in more detail on pages 25-28. It should also be noted that during our review of the documentation provided to RVK around the seven property transactions we were asked to evaluate, we were not able to identify documentation or evidence of the thorough completion of every step listed above for every property.

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



TLO staff utilize manual electronic file storage and spreadsheets for monitoring and tracking of real estate investment activities.

### APFC Real Estate Investment Capabilities

APFC has a staff of four individuals that manage real estate investments internally. The table below indicates their names, title and experience.

Name	Title	Years of Industry Experience	Years with APFC
Rosemarie Duran	Director of Real Estate Investments	30	27
Tim Adreyka	Senior Portfolio Manager – Real Estate	34	2
Christi Grussendorf	Real Estate Analyst	15	28
Karen Emberton	Real Estate Analyst	5	22

The team has been consistent over time, with three of four team members employed by the APFC for over twenty years.

The APFC also employs several real estate advisors that assist the team with a number of functions, including due diligence and overseeing property management. The APFC indicated they currently work with the following advisors:

- CBRE Global Investors (European real estate advisor--all property types)
- LaSalle UK (UK real estate advisor—all property types)
- CS Capital (US real estate advisor---office and industrial)
- Sentinel Real Estate (US real estate advisor—multifamily/office/industrial)
- L&B Realty (US real estate advisor—retail/office/multifamily/hotel)

Per APFC procedure documents, the due diligence process is driven by these advisors. They assist staff by submitting: deals for review, offering memorandums, underwriting, rationale for

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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



portfolio fit, letter of intent, Investment Committee due diligence documents and formal recommendation to Staff. The APFC also works with a number of partners to assist with the following services:

- Appraisers – provide independent property valuation (30 providers referenced)
- Financial Auditors – provide independent audits of properties (9 providers referenced)
- Property Managers – oversee daily operations of properties (23 providers referenced)
- Leasing Managers – oversee leasing of properties (31 providers referenced)
- Legal Counsel – review and negotiate term of purchase and sale agreements (providers not referenced)

Internally, both APFC Real Estate and Finance staff use the Yardi Voyager platform to track real estate investments. This latter observation indicates access to a real estate tracking technology to maintain and monitor aggregate exposures across a commercial real estate portfolio.

### Evaluation of Specific Real Estate Transaction Due Diligence

RVK's research group broadly views institutional quality due diligence in the commercial real estate space to consist of two main components:

- 1) Asset Level Due Diligence: this determines the quality and expected risk-adjusted return of a commercial real estate property (or strategy) in isolation.
- 2) Portfolio Level Due Diligence: this determines the appropriateness of a commercial real estate property (or strategy) in the context of a broader portfolio of investments, given a set of stated client goals, restrictions and sensitivities.

Given this approach we separate our evaluation of TLO's due diligence process vs. RVK's recommended institutional best practices into the above two categories. We first evaluate the due diligence conducted on the requested seven property-level transactions at the asset level and then expand to the portfolio level.

### Asset Level Due Diligence vs. Institutional Best Practices:

RVK views the primary purpose of asset-level due diligence to be the identification of investments in specific properties that will allow clients to access above-average risk-adjusted returns in a targeted commercial real estate investment space. As such, asset-level due diligence typically encompasses both the sources and extent of the investment's projected return (usually through tools such as cash flow modelling and valuation analysis), and the identification of the major risks inherent in each investment, along with some gauge of the probability and severity of those risks. Given the large number of different factors and counterparties involved in the successful operation and income generation of most commercial real estate properties, best-practices asset-level due

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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



diligence in this area is generally quite extensive, and often encompasses a significantly broader scope than due diligence in many other asset classes.

RVK's asset-level due diligence "best practices" checklist is offered for clarification purposes regarding the criteria considered in evaluating commercial real estate strategies/transactions. This checklist represents the analysis and documentation of due diligence RVK's research group typically expects to find when conducting an evaluation of the commercial real estate transactions executed by institutional quality real estate strategies.

At the asset level, the materials reviewed by RVK indicate due diligence best practices were broadly, though in some categories not completely, followed for the seven property transactions we evaluated. Exact alignment with RVK's best practices varied slightly on a property-by-property basis. Broadly, evidence of sufficient due diligence was present to plausibly argue that asset-level due diligence best practices were followed in most, though not all, of the major due diligence categories our research group requires of the investors we analyze. Broadly, sufficient documentation was available to conclude that the asset-level due diligence conducted on each of the properties generally conformed to RVK's overall best practices standards.

One key area we note in our review is a general lack of TLO materials outlining the process and resources involved in the TLO's idea generation. Input from a range of internal or external parties may drive decision-making in a best-practices process, and best practice processes often exhibit a similarly broad range of rationales behind their property selections. However, in this case, sufficient documentation is lacking to determine whether or not the idea generation behind these transactions approached any type of best practice standards. Investment theses referenced in the materials provided to RVK were typically summarized very briefly, usually in memos outlining "use of leverage to increase returns and reduce risk to the trust," and in some cases a desire to acquire properties outside existing geographic holdings. However, these memos do not appear to go into greater detail as to why the specific properties under consideration were selected over other comparable options. RVK views idea generation as a critically important investment function, so we view the lack of detailed evidence of idea generation to be significant.

This concern over a lack of a documented process for idea generation is more critical than it may seem. When combined with the relative few transactions the TLO has executed for the AMHTA, lack of evidence that there is a deep and sustained source of, and robust filter for, ideas for both acquisitions and divestitures (when necessary) calls into question the ability of the TLO to sustain a successful commercial real estate investment program over the long run. This capacity to generate commercial real estate transaction "idea flow" is one of the central criteria RVK uses to assess commercial real estate asset management firms for our institutional investment clients.

The table below offers a concise summary of property-level due diligence reviewed by RVK. Classification of due diligence encompasses three broad categories; including investment

# APPENDIX B (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



screening, approval process, and deal pursuit and due diligence.

Property Due Diligence Checklist	Cordova (AK)	Cummins (AK)	IRS (UT)	Israel (WA)	Promontory Point (TX)	North Park (TX)	Amber Oaks (TX)
<b>INVESTMENT SCREENING</b>							
Initial Screening	Complete	Complete	Complete	Complete	Complete	Complete	Incomplete
Building Condition	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Building Location Analysis	Incomplete	Complete	Complete	Complete	Complete	Complete	Complete
Metro Analysis	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Tenant & Lease Review	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Operations Review	Unavailable	Complete	Complete	Unavailable	Complete	Complete	Complete
Cash Flow Modeling	Complete	Complete	Complete	Complete	Complete	Complete	Complete
<b>APPROVAL PROCESS</b>							
Reconciliation of Value	Complete	Complete	Complete	Complete	Complete	Complete	Complete
SWOT Analysis	Complete	Incomplete	Complete	Incomplete	Complete	Complete	Complete
Comprables Pricing Analysis	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Seller Evaluation	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Entitlement/Permit Review	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Insurance	Complete	Complete	Complete	Complete	Complete	Incomplete	Complete
Financing	Complete	Complete	Complete	Complete	Complete	Unavailable	Complete
Tax Due Diligence	Complete	Complete	Complete	Incomplete	Complete	Complete	Complete
Environmental Risk Assessment	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Approval	Complete	Complete	Complete	Complete	Complete	Complete	Complete
<b>DEAL PURSUIT AND DUE DILIGENCE</b>							
Full Inspection	Complete	Complete	Complete	Complete	Incomplete	Incomplete	N/A
Counterparty Due Diligence	Unavailable	Unavailable	Unavailable	Unavailable	Unavailable	Unavailable	Unavailable
Legal	Incomplete	Complete	Incomplete	Complete	Incomplete	Incomplete	Incomplete
Transaction	Complete	Complete	Complete	Complete	Complete	Complete	Complete
Best Practices Generally Followed?	YES	YES	YES	YES	YES	YES	YES

In general, we typically conclude due diligence best practices have been broadly applied by a manager/transaction if we are able to find concrete evidence that:

- 1) A substantial percentage of checklist items have been completed/assembled, AND;
- 2) A meaningful number of checklist items in each major due diligence *category* have been completed/assembled.

We would not expect any given transaction or strategy to “pass” every one of our 21 categories, or to provide evidence of completion for every one of our underlying checklist items. We do, however, generally expect that a best-practices due diligence process will complete the key due diligence steps necessary in the majority of categories, as well as provide evidence of completion of most items, or at a minimum the most crucial items, in most categories.

It should be noted that, for the lineup of seven transactions within the scope of this project, the

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



majority of completed checklist items were found in the respective properties' appraisal reports, purchase agreements, or other third party documents, which were assembled by various third party vendors. As such, in our view it is likely that these third party vendors, and not the TLO, conducted the bulk of due diligence for the transactions we analyzed. As a result, we believe that these transactions are likely to be cases of "outsourcing," with the bulk of due diligence executed by third parties. Absent the work of the appraiser, legal counsel and other third parties, the due diligence of these properties would not approach RVK's best practices standards for commercial real estate due diligence. As such, we view outsourcing to fill a crucial role in this due diligence process.

More broadly, divergence with RVK best practices was relatively limited across all properties but varied somewhat by property, with some due diligence efforts (Cummins) displaying research and documentation superior to others (Cordova). Divergence with RVK best practices also varied considerably by category; with categories such as metro analysis, building condition analysis, and tenant and lease analysis generally providing evidence of the most thorough research and strongest quality of work, along with the purchasing agreements structured around each transaction. "Seller evaluation" in RVK's summary table above is labeled "N/A" because although RVK did not find evidence of in-depth seller evaluations through our review of materials, many of the purchase agreements offer sufficient protections regarding the non-transferability of seller liabilities and as such, RVK did not feel this gap introduced major risks into the purchase of specific assets. Counterparty due diligence is shown as "unavailable," as TLO staff offered comments as to their due diligence process regarding evaluation of key counterparty risks; however, RVK found little direct evidence supporting this process. RVK's "legal" category represents a broad review of any past or outstanding legislative action and potential or outstanding legal claims around a property. While RVK found due diligence relative to best practices to be lacking in this category, given the thoroughness of the purchase agreements RVK does not feel this area represented a material gap in general best practices guidelines.

Given the materials that have been made available to RVK and the variability that we broadly expect to encounter across different asset-level due diligence processes as a result of the various unique features around any given property transaction, we believe that due diligence best practices have likely been generally followed for the seven property-level transactions. Given the lack of evidence of complete due diligence in some areas, we cannot definitively confirm that due diligence best practices were followed in all categories and sub-categories for all seven property transactions. However, we would generally expect the due diligence around most transactions in the commercial real estate space to fall short in a few of our categories, and do not consider the shortfalls we encountered to be substantial or pervasive enough to represent definitive non-conformance.

### **Asset Level Due Diligence: Key Takeaways:**

[www.RVKInc.com](http://www.RVKInc.com)

January 30, 2018

# APPENDIX B

## (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



1. Once assets were identified by the TLO, asset-level due diligence best practices appear to have been generally followed in the due diligence conducted on the seven property transactions reviewed by RVK.
2. Complete evidence of full conformity to due diligence best practices was not available for all categories and sub-categories of due diligence across all property transactions. However, the number of categories for which evidence was unavailable is within our general expectations within the commercial real estate space, due to relatively high variability across properties, transaction agreements, and purchaser documentation practices.

*Further Notes on the RVK Due Diligence Checklist:*

RVK's checklist is generally meant to cover the major points of analysis and related documents we would expect a property-level due diligence to cover prior to the purchase of a commercial real estate asset. As briefly noted earlier, this checklist is:

- 1) **Non-exhaustive.** For any individual transaction, we expect a thorough due diligence to require one or more documents not listed in the checklist, likely related to property-specific or jurisdictional features and issues. Our list is meant to include the basic steps and documents required for a due diligence of most commercial real estate assets, but should not be expected to include all steps and documents needed to conduct complete due diligence on all properties.
- 2) **Non-universal.** For many properties, it will not be necessary to include all steps and documents referenced by the checklist. For example, newer properties may not have applicable past transactions that can be analyzed. Additionally, the due diligence of properties in areas without a high degree of seismic activity will not require the review of a seismic report. For this reason, we would hesitate to conclude that a due diligence process falls short of best practices due to the results of any single item or category.

As previously noted, we generally expect to see evidence that either a majority or, at minimum, several checklist items in each major category have been completed over the course of a due diligence. Such evidence could take the form of either a relevant document, or references to/analysis of such a document in another format, such as a due diligence report, investment committee memo (in the case of a real estate fund), or appraisal report. In cases where there is evidence that no checklist items have been completed for a major due diligence category, such as cash flow modelling, analysis of comparable transactions, or the review of a property's operations, we would strongly suspect a lack of adequate due diligence around the property's purchase, and would typically view the associated due diligence as falling short of our best-practices. We again note that there are limits to the applicability of this tool, particularly with

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



respect to less typical commercial real estate transactions. For example, only a limited subset of this checklist would likely be relevant when evaluating the purchase of farmland.

### **Portfolio Level Due Diligence vs. Institutional Best Practices:**

Due diligence in a portfolio context is far more variable than due diligence at the asset-level due to varying client needs and restrictions; as such, we expect portfolio-level analysis to range broadly in both scope and content. A wide array of processes may be representative of “best practices.” At the institutional investor level we believe best practices for the purchase of new assets and their inclusion in commercial real estate portfolios should incorporate the following elements of analysis:

- 1) **Alignment with client goals:** some form of analysis should exist evaluating the ability to advance the client’s goals and objectives for the total fund. In the case of commercial real estate, this applies to both the overall strategy governing the real estate investment program as well as the individual property investments themselves. This analysis typically includes both a review of historical strategy/property performance and an evaluation of the composition of the strategy or property’s current income and most recent sale prices. Additionally, at the portfolio level this analysis generally considers the role an investment is expected to play in the context of the broader asset class or sub-asset class and the total fund as well. Risk/return attributes and expected risk-adjusted returns are typically evaluated relative to other investments for purposes of asset class structuring and diversification.

RVK found a lack of support regarding the real estate transactions and the alignment with AMHTA investment goals and objectives. Both policy documents, the AMPS and RMS, lack guidance on an entity-level asset allocation strategy, as well as the structuring of the real estate asset class (core vs. non-core assets). RVK defines structuring the real estate asset class as the balance between core assets, or those investments in existing, high occupancy, and generally stabilized properties in predominantly primary markets, where the primary return driver is income, versus those in non-core investments which typically require a greater degree of repositioning, releasing, or redevelopment. Non-core assets typically offer greater appreciation potential and may be located in primary or secondary markets. Relevant policies fail to offer clear guidelines on appropriate risk/return attributes from individual investments or at the asset class level, and offer no diversification objectives for those assets managed by the TLO directly or as a broader portfolio integrated with those assets managed by the APFC. This gap in policy development is a critical oversight in the AMHTA’s ability to assess any single investment’s value-add to the AMHTA portfolio.

2. **Analysis of risk:** some form of downside scenario testing or other “stress” testing should

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



exist, evaluating the expected performance of a given strategy or property in an adverse market environment. This typically includes a scenario evaluating the likely “fire sale” price of a portfolio or property in the event that an adverse market environment unexpectedly requires the client to divest. Often, this analysis will include past strategy or property transactions during stressed market periods, such as the Great Financial Crisis.

In our analysis of the requested property transactions, based on the materials provided, we found evidence of analysis on risk control, chiefly through various types of cash flow modelling or other stress testing at the property level. However, RVK found little evidence of analysis at the portfolio level to support a focus on prudent risk control. Specific portfolio level risk controls vary across asset classes but real estate risk controls often include stress testing, review of aggregate leverage, and reviewing/structuring the balance of property types and geographies to mitigate potential downside risks. RVK did not find evidence of documentation supporting the optimization of the risk/return tradeoff at the portfolio level.

- 3. Analysis of diversification potential:** some form of analysis should exist gaging the existing diversification of the client’s commercial real estate portfolio relative to that of a broad benchmark (for example, the NCREIF Open Ended Diversified Core Equity Index or “NFI-ODCE”), and likewise gaging the extent to which an investment in the strategy or property in question will either contribute to or detract from diversification. Portfolio-level diversification is typically gaged with regard to region and property type at an absolute minimum, but diversification analysis may also examine a portfolio from several additional standpoints dependent on client needs and goals.

RVK’s review of policy and due diligence documents found little evidence of consideration for diversification potential within the TLO real estate portfolio. The current TLO real estate portfolio reflects a concentration of investments in two geographic regions (west and south) and is predominantly invested in the office sector, with a limited allocation to industrial assets. The RMS offers fiduciaries no clear guidance on the appropriate level of diversification across geographies or property sectors and in RVK’s view, the TLO real estate portfolio lacks a sufficiently diverse allocation among with assets. RVK’s evaluation of diversification across property types and regions is highlighted by our comparison of the seven properties vs. the NFI-ODCE index, shown in the pie charts at the conclusion of this section.

Additionally, current AMHTA policies lack an entity-wide view to consider diversification, or duplication, potential of the real estate portfolio when reviewing assets as a single portfolio and incorporating those assets managed by the APFC. As noted previously, best practice guidance recommends cash and non-cash assets be considered as a single portfolio when establishing investment policies, in order to apply prudence at the portfolio

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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



level and move toward diversified asset allocation. The Western States Land Commissioners Association's Principles of State Trust Portfolio Management states specifically that land minerals, buildings, and financial assets should be managed as a single portfolio. The lack of integrated view of the AMHTA assets at the portfolio level may result in unintended portfolio exposures.

**4. A clear policy statement guiding execution:** some policy statement and supporting rationale for how the fund is to execute its investment program.

RVK found no clearly stated policy nor supporting rationale in the documents we reviewed for the decision to use the TLO as the commercial real estate investment arm of the AMHTA versus relying on the larger, broader and more diversified capabilities of the APFC. There may be sound reasons for doing so, but we could not discern them from our review. Moreover, we also could not find any rationale at the AMHTA policy level that supported the investment of real estate proceeds (in this case the proceeds from the AMHTA's land holdings) in more real estate, rather than deepening the degree of diversification by allocating these proceeds to the AMHTA's financial assets managed by the APFC. There may be sound reasons for doing so, but again, we could not discern them from our review.

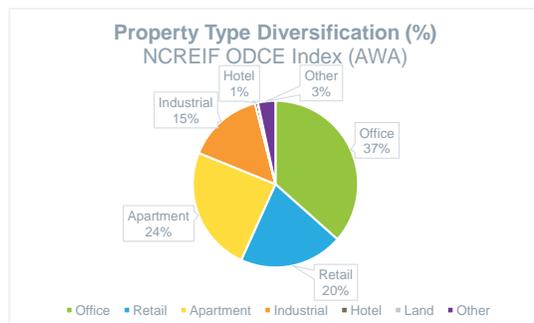
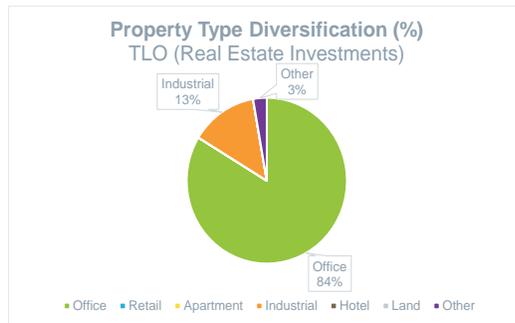
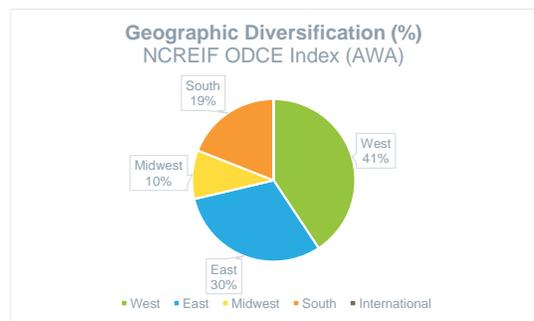
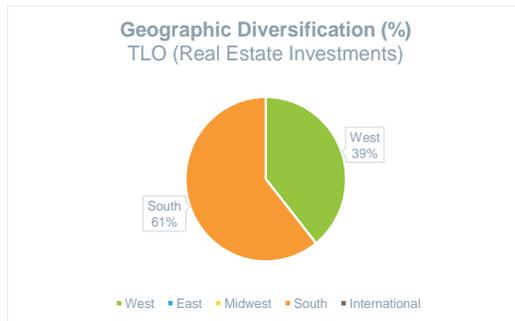
The absence of these clear policy decisions and the underlying rationales is critical to the request that we comment on whether reliance on the TLO rather than the APFC for a long-term commercial real estate investment constitutes best practice. Without them, we are left with no underlying analysis of these decisions to review and comment upon and must conclude that their absence itself does not constitute best practice from an institutional investment management perspective.

# APPENDIX B (Continued)

AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



## TLO Real Estate Investments vs. NCREIF ODCE Index (Asset Weighted Average)



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# APPENDIX B

## (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies, Objectives, and Real Estate Transactions via TLO



### Concluding Thoughts

RVK offers the following summary conclusions for our evaluation of the AMHTA's objectives and policies, areas for improvement, the AMHTA Board's decision to utilize the TLO to invest in commercial real estate, and the appropriateness and potential duplication of the TLO's real estate investments relative to those carried out by the APFC, and whether or not institutional due diligence best practices were followed for seven specific real estate transactions.

RVK believes the AMPS falls short of a best practice policy statement when viewed through the lens of an institutional investor with a focus on state land trusts. The AMPS has created an organizational oversight whereby a single fiduciary body does not oversee the entity-wide AMHTA assets. In its current form, the AMPS fails to outline objectives of the aggregate assets, including a stated asset allocation strategy, risk tolerance, and monitoring guidelines incorporating both cash assets and non-cash assets. The AMPS's lack of an entity-wide view challenges the Board's ability to fulfill its fiduciary responsibility in aggregate to provide oversight, cost control, and prudent diversification of all Trust assets. RVK concludes that significant improvements could be achieved by creating an organizational structure whereby cash and non-cash assets are evaluated by a single fiduciary body and developing and documenting an aggregate asset allocation policy.

Additionally, RVK believes the Resource Management Strategy falls short of a best practice policy document. The RMS appears to evolve over time in response to desired real estate investment activities rather than the policy statement driving decision-making for the AMHTA Board and TLO Staff. Investment decision-making should be guided by the principles outlined in the policy document, not vice-versa.

Further, AMHTA income needs do not represent a prudent rationale for using the TLO for direct real estate exposure over investing additional assets in the diversified portfolio managed by the APFC, or pursuing a separately managed strategy focused on income generation. Use of the TLO and the creation of a national direct commercial real estate investment program may well represent an appropriate avenue for revenue generation; however, discussion and documentation of that fundamental decision and the rationale for it set forward in a comprehensive fashion is a critical gap in the AMHTA AMPS.

At the highest, most conceptual level, the principles outlined in the TLO Resource Management Strategy overlap with those documented in the APFC Real Estate Investment Strategy. The RMS offers broad, arguably vague, guidance to fiduciaries on permissible investments, risk guidelines and controls, portfolio growth and performance objectives, and lacks benchmarks for evaluation of progress toward the achievement of these objectives. In contrast, the APFC documents contain specific performance objectives, risk and diversification tolerances, and long-term objectives of the real estate portfolio within the APFC.

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## APPENDIX B (Continued)

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AK Division of Legislative Audit: Evaluation of AMHTA Policies,  
Objectives, and Real Estate Transactions via TLO



RVK reviewed the property-level exposures and we note no specific property duplication exists between the TLO and APFC portfolios. RVK does note, however, the relatively high concentration of property exposures in certain geographic areas. Additionally, real estate investment programs managed by both the TLO and the APFC presents the opportunity for overlapping market-specific exposures, thereby potentially reducing diversification and thus potentially introducing unnecessary risk to long-term returns.

RVK believes the decision by the AMHTA Board to invest in commercial real estate via the Trust Land Office does not constitute best practice and would recommend the APFC execute real estate investment activities. The TLO demonstrates acceptable due diligence researching and buying properties; however, the APFC offers deeper resources and a strong advisor network, and the team is better equipped to manage an institutional quality real estate portfolio.

Based upon asset-level due diligence materials made available to RVK and the variability we broadly expect to encounter across different asset-level due diligence processes, we believe due diligence best practices have likely been generally followed for the seven property-level transactions.

RVK views portfolio-level due diligence as far more variable than asset-level due diligence given varying client needs and restrictions. We believe institutional investor best practices at the portfolio-level should incorporate an analysis of alignment with client goals, risk assessment via downside scenario or other "stress" testing, the diversification potential of the investment relative to the existing asset class portfolio of investments, and offer a clear policy statement guiding the execution of the investment program. RVK generally observes a lack of documentation in these critical areas for portfolio level due diligence. The absence of documentation and support of these portfolio level due diligence activities leads RVK to conclude that due diligence falls short of best practices in institutional investment management.

# Agency Response from the Office of the Governor

STATE CAPITOL  
P.O. Box 110001  
Juneau, AK 99811-0001  
907-465-3500  
Fax: 907-465-3532



550 West Seventh Avenue, Suite 1700  
Anchorage, AK 99501  
907-269-7450  
fax: 907-269-7463  
gov.alaska.gov  
Governor@alaska.gov

Governor Bill Walker  
STATE OF ALASKA

May 2, 2018

Kris Curtis  
Legislative Budget and Audit Committee  
Alaska State Legislature  
P.O. Box 113300  
Juneau, AK 99811-3300

RECEIVED

MAY 03 2018

LEGISLATIVE AUDIT

Dear Ms. Curtis:

Thank you for the opportunity to respond to the Legislative Budget and Audit Committee regarding the preliminary audit reports for the Alaska Mental Health Trust Authority Asset Management and other select issues.

Your findings and recommendations did not directly address Boards and Commissions, but we would like to provide some information regarding current board training materials that will be sent to the Executive Director of the Trust, the Executive Director of the Trust Land Office, and the Chair of the Board of Trustees.

A short primer on the basics of Robert's Rules and Parliamentary Procedure, and a list of rules for the Chair to ensure adherence by the board and staff are meant to reinforce the importance of the Open Meetings Act and the States Ethics Law while conducting public and executive session meetings. We will present these papers to the full board as well at the next public meeting, and strongly encourage the board to use them in the future.

Sincerely,

A handwritten signature in black ink, appearing to read "Shirley Marquardt".

Shirley Marquardt  
Director  
Boards and Commissions

SM/li

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# Agency Response from the Department of Revenue



THE STATE  
of **ALASKA**  
GOVERNOR BILL WALKER

## Department of Revenue

COMMISSIONER'S OFFICE  
State Office Building  
333 Willoughby Avenue, 11<sup>th</sup> Floor  
PO Box 110400  
Juneau, Alaska 99811-0400  
Main: 907.465.2300  
Fax: 907.465.2389

April 23, 2018

Kris Curtis, Legislative Auditor  
Legislative Budget and Audit Committee  
Division of Legislative Audit  
P.O. Box 113300  
Juneau, AK 99811-3300

RECEIVED

APR 24 2018

LEGISLATIVE AUDIT

RE: Confidential Preliminary Report, Department of Revenue, Alaska Mental Health Trust Authority Asset Management and Other Select Issues

Dear Kris Curtis:

Thank you for an opportunity to respond to the Confidential Preliminary Report, Audit Control Number 04-30090-18 ("Audit Report"). Your letter dated April 11, 2018 requested a written response to recommendations in the report addressed to the Department of Revenue ("Revenue").

The Audit Report makes findings respecting actions taken by the Alaska Mental Health Trust Authority ("AMHTA"). While established as a public corporation of the State within Revenue,<sup>1</sup> the AMHTA was created to have significant independence from Revenue and the State. This independence arises largely from the settlement of the mental health trust litigation (*Weiss v. State*), and the fiduciary role given the AMHTA to serve as trustee of the mental health trust.<sup>2</sup>

None of the recommendations in the Audit Report are addressed to Revenue. It would be inappropriate for Revenue to respond respecting recommendations directed at the independent AMHTA. If you have any questions or would like to discuss this response, please feel free to call Deputy Commissioner Michael Barnhill at 465-3669.

Sincerely,

A handwritten signature in black ink, appearing to read "Sheldon Fisher".

Sheldon Fisher  
Commissioner  
Department of Revenue

<sup>1</sup> AS 47.30.011(a).

<sup>2</sup> AS 37.14.007(a).

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# Agency Response from the Department of Natural Resources



THE STATE  
of **ALASKA**  
GOVERNOR BILL WALKER

Department of Natural Resources

COMMISSIONER'S OFFICE

550 W. 7<sup>th</sup> #1400  
Anchorage, AK 99501  
Main: 907.269.8431  
Fax: 907.269.8918

May 3, 2018

Kris Curtis, CPA, CISA  
State of Alaska, Division of Legislative Audit  
PO Box 113300  
Juneau, AK 99811-3300

RECEIVED

MAY 03 2018

LEGISLATIVE AUDIT

Re: DNR Response to the April 11, 2018 transmittal of the preliminary audit report on *Department of Revenue, Alaska Mental Health Trust Authority Asset Management and Other Select Issues, February 8, 2018*

Dear Ms. Curtis,

Thank you for your review and your perspective of the Alaska Mental Health Trust Authority (AMHTA) and Department of Natural Resources (DNR) Trust Land Office (TLO) actions as prescribed by the audit. We will utilize this report to improve various aspects of our operations, evaluate the effectiveness of the management of trust owned land, advance further communication with the Legislature and Alaska Permanent Fund Corporation (APFC), and continue to ensure that all actions and decisions are being made in the best interest of the trust and its beneficiaries.

DNR is providing comment on the preliminary audit report as it relates to DNR TLO authorities, policies, and actions. Although DNR does not agree with many statements in the report, this response is limited to aspects of the report that are specifically directed at DNR TLO, particularly Recommendations #1 and #3. DNR understands and expects that the AMHTA and its board will address issues affecting its authorities, policies, and actions. DNR TLO will work in concert with the AMHTA in taking actions in response to this report.

#### **DNR's Relationship to the AMHTA**

AMHTA is required by AS 37.14.009 to contract with DNR to manage the land assets of the trust, and a 2005 Memorandum of Agreement (MOA) sets forth the principles that govern the relationship between the AMHTA and DNR and the responsibilities of the parties with respect to management of trust land. Ultimately, however, management of trust land must be consistent with trust principles imposed on the State of Alaska by the Alaska Mental Health Enabling Act (AMHEA) and trust law. One of the important goals of managing trust land is to generate revenue to be used by the AMHTA to improve the lives of trust beneficiaries. The TLO is the identified office within DNR that manages trust land under the MOA with AMHTA and according to trust principles. The TLO, led by its executive director, is responsible for managing the trust's non-cash assets or, as prescribed more specifically, trust land. The settlement of the *Weiss* litigation approved DNR as manager of the land because it had the experience and expertise to appropriately manage the trust land assets, inclusive of all the responsibilities that come with managing all related interests that come with "land."

In conducting that business, and consistent with regulation, significant trust land management and disposal decisions are made after consultation with the AMHTA board of trustees. The TLO evaluates its prospective management decisions in the context of the land portfolio it has been tasked with managing, and does not evaluate the land holdings of the APFC that are derived from investments of the Alaska Mental Health Trust Fund by the APFC. It would be inappropriate for TLO land management actions to be driven by investment decisions at the APFC for which TLO (or the trustees for that matter) have no control. The appropriate level of trust portfolio-wide asset distribution and diversification oversight, evaluation, and guidance rests with the board of trustees. Decisions to acquire land and interests in land, inclusive of purchasing buildings, must be approved by the board. This is done through the public process of board meetings. TLO cannot unilaterally take action to acquire new land assets for the trust.

Revenues from the management of trust land are transferred to the AMHTA. The TLO does not have the authority to spend those revenues outside of its approved budget or unless the AMHTA otherwise gives it such authority. Although the TLO may make recommendations concerning funding for certain projects or purposes, it does not control the source of the funds that are directed to it.

Using AMHTA allocated funding, the TLO has the authority to manage the trust land portfolio to increase its value and to acquire new land.<sup>1</sup> Land includes any appurtenances to the land, such as a building. Once the AMHTA approves a land development project or land acquisition project, the TLO has the authority under existing law to implement and manage those projects, including any improvements. In fact, under trust principles, the TLO is obligated to consider whether and how to make non-performing assets productive in the long-term, through actions such as authorizations, land development improvements, replacement, disposal, or exchanges.

#### **Response to Recommendations**

The report finds that the AMHTA should not invest in commercial real estate through the TLO and that the TLO does not have the authority to manage commercial real estate investments. The report does not adequately distinguish between actions that are solely investment actions that involve commercial real estate investments, which it concludes TLO should not handle, and TLO's management decisions regarding the trust's land corpus, which includes commercial real estate, which management by TLO is statutorily mandated. Ultimately the decision to use the TLO to conduct any land acquisitions and subsequent management will be made by the board of trustees. The AMHTA has begun discussions with the APFC and potential alternatives might prescribe how the TLO would or would not be used in regard to real estate investments.

The TLO conducted the AMHTA's real estate investments consistent with its fiduciary duties, which provided a steady stream of spendable income that was able to be used to improve the lives of the beneficiaries. The TLO demonstrated its staff has the skills and knowledge to professionally manage commercial real estate investments. Over the course of the years since the TLO began purchasing real estate investments for the trust through a public board approval process, \$6.03million in spendable income was distributed to the trust from those investments. By the outlay of \$39.1 million in principal, with the use of mortgaging some of those properties, the trust now owns a \$92.4 million portfolio with approximately a 50% debt ratio. In addition, \$5.2

<sup>1</sup> AS 38.05.801; 11 AAC 99.010; 11 AAC 99.020.

million of the debt was repaid from the property rents and income. This portfolio of high quality, well managed, and conservatively positioned commercial real estate assets has proven to be a very successful investment of trust principal generating stable and predictable income while the portfolio has appreciated.

The AMHTA has matured substantially since its inception 24 years ago. Conditions have changed with the economic climate, expertise within the TLO, and land management opportunities since the time of the settlement. It is always appropriate to consider the overall management and investment strategies of the trust, and to consider changes and opportunities that may be available. As recommended, the AMHTA has begun discussions with APFC on the treatment of the trust's commercial real estate investment portfolio. The TLO will participate in discussions with AMHTA and the APFC as appropriate. It would be inappropriate to take immediate action to transfer or divest the trust of its real estate investment properties without the benefit of the progression of these discussions and an analysis of what action with respect to those properties will be in the best interest of the trust and its beneficiaries. For example, transferring properties to the APFC may cause an immediate reduction in available spendable income that can be used on beneficiary programs because a smaller portion of the income generated by the properties will be allocated to the trust if the current funding structure remains. The trust only receives 4.25% of the four-year average annual value of the APFC managed investments to be used as spendable income.

The TLO staff have commercial real estate expertise which has been demonstrated as effective. We agree with the audit report conclusions that the TLO has performed asset level due diligence that conforms to best practices. Within the real estate investment portfolio that the TLO manages, there exists geographical and property type diversification with high quality buildings leased to a mix of federal, state, and commercial tenants in strong economic growth areas throughout the western U.S.

The DNR disagrees, however, with the report's conclusion that the TLO's management of these commercial real estate investments inflated investment costs. Its conclusion was based on an erroneous understanding of the use of TLO staff and their allocation of duties. The report assumes that the TLO has no need for real estate staff with real estate expertise if the TLO is not involved with a real estate investment program. That is simply incorrect. Whether or not the TLO is managing the real estate investment properties, it still has a statutory and fiduciary obligation to manage the trust's other existing buildings and commercial real estate within the original trust land portfolio. Accordingly, only a portion of management costs have been associated with the real estate investments.

The DNR also would like to clarify the use of trust owned buildings known as Program Related Investment (PRI) properties. The report states that PRI properties may provide below market returns while being used for program purposes. Any asset the trust owns, whether purchased, donated, or acquired by some other means, can be used for program related purposes if deemed appropriate by the board of trustees and the TLO.<sup>2</sup> If PRI properties could only be used for program purposes, it takes away the TLOs ability to actively manage these properties efficiently, responsibly, and in the best interest of the trust and its beneficiaries over the long-term.<sup>3</sup> It is hoped that those buildings used for beneficiary programs or purposes (and at a minimum the PRI portfolio) will be a self-sustaining way to serve beneficiary groups. However, the trust does have the ability to use facilities

<sup>2</sup> AS 37.14.007(b)(11); 11 AAC 99.020; 11 AAC 99.110.

<sup>3</sup> 11 AAC 99.020.

at a financial loss if it is deemed in the trust's interest to do so because the program benefits outweigh that financial loss.

PRI buildings are often used for program purposes because of the nature of a building and their fit for program use. However, unless there is some deed restriction, there is nothing that mandates that property will always be used for program related purposes throughout the life of the property or the perpetual life of the trust itself, regardless of how or when the property was acquired.

Finally, the TLO agrees with the report's recommendation to work with the AMHTA to review and revise the Asset Management Policy Statement (AMPS) and the Resource Management Strategy (RMS) as necessary. The AMPS is the board's expression of the asset management philosophy, objectives, guidelines and expectations of the AMHTA. It follows that the TLO's RMS reflects that philosophy and direction in more detailed management strategy for the assets. DNR agrees that the RMS will be reviewed to ensure that there is clear guidance of responsible management of the trust's real estate portfolio, with appropriate goals, diversification, structure and alignment with trust policies. To the extent that investment and management decisions would rest with the TLO, the RMS will also be reviewed to determine if any changes are necessary to incorporate industry best practices and compliance with state investment laws.

#### Conclusion

DNR is gratified that the legislative audit found that the AMHTA has consistently worked to further the best interest of its beneficiaries. Likewise, actions taken by the TLO have been made in the best interest of the trust and its beneficiaries. As recognized in the report, the TLO followed appropriate due diligence in each of the real estate investment program acquisitions and the results were positive, creating increased spendable income that was spent to improve the lives of the beneficiaries while increasing the overall value of the trust corpus.

DNR through the TLO is committed to working with the AMHTA, APFC, legislators, and other stakeholders to ensure that future TLO activity meets high standards for quality of public service and maximum effort to meet its fiduciary obligations and improve the lives of trust beneficiaries.

Sincerely,

  
Andrew T. Mack  
Commissioner

for 5/3/18

Cc: Wyn Menefee, Executive Director, Alaska Mental Health Trust Lands Office  
Mike Abbott, Chief Executive Officer, Alaska Mental Health Trust Authority

# Agency Response from the Alaska Mental Health Trust Authority



3745 Community Park Loop, Suite 200  
Anchorage, AK 99508  
Tel 907.269.7960  
www.mltrust.org

May 1, 2018

Kris Curtis  
State of Alaska, Division of Legislative Audit  
PO Box 113300  
Juneau, AK 99811-3300

RECEIVED  
MAY 01 2018  
LEGISLATIVE AUDIT

Re. Response to Legislative Audit Report

Dear Ms. Curtis,

I am writing on behalf of the Board of Trustees of the Alaska Mental Health Trust Authority to respond to your audit report. We have reviewed the report conclusions and recommendations and are providing a response in the attached document.

It is clear from the report that well intentioned people can have a difference of opinion, which means clarification is needed to ensure the Trust's best performance for the beneficiaries. We appreciate the audit's recognition of the Trustee's motivations. We maintain our position that the Trust's investment choices are appropriate and allowable and have increased the Trust's spendable income. We will undertake a careful examination of the impacts of recommendations one and two on service delivery to our beneficiaries. Ultimately, if these recommendations are found to be in the best interests of the beneficiaries we will implement them. We concur with report recommendations three and four and have already taken actions to plan and execute changes necessary to implement those recommendations.

From its inception 24 years ago, the Trust continues to evolve and grow and we continually seek ways to improve our service to beneficiaries. The audit is a helpful tool for continuing this process and I thank you for your efforts to help build a strong organization.

Sincerely,

A handwritten signature in blue ink that reads "Mary Jane Michael". The signature is written in a cursive style.

Mary Jane Michael  
Board Chair

## Alaska Mental Health Trust Authority Response to Preliminary Audit Report

May 1, 2018

### Executive Summary:

The audit report makes four recommendations. Two of those recommendations (#3 & #4) deal with process, procedure and operational issues. The Trust concurs with these two recommendations and appreciates the input. The Trust is already implementing substantial portions of these recommendations through the organizational governance initiative that was launched a year ago. The other two recommendations (#1 & #2) deal with the Trust's authority to make management decisions pertaining to how a small class of assets are invested. The Trust will consider accepting those recommendations, but cannot commit to any specific action without a thorough evaluation process that includes discussions with our advisory boards, Alaska Permanent Fund Corporation, and other stakeholders. Since the likely outcome of these recommendations will be less resources available for grants, ultimately these decisions must be determined to be in the best interest of Trust beneficiaries.

### Background Information:

The Trust is a complex entity and is continuously evolving in response to changing beneficiary needs and the overall environment. A Trust beneficiary is an Alaskan who experiences mental illness, developmental disabilities, substance use disorder, traumatic brain injury, or Alzheimer's disease and related dementia. Much of the Trust's current governance and operational structure is based on extensive dialogue and negotiations that took place over many years. These communications and dialogue with stakeholders were the foundation for the 1994 settlement as well as the ongoing guidance and direction of the Trust. The Trust considers this dialogue and ongoing relationship between Trust management and advisory boards, non-profit and community partner agencies, and the residents that qualify as Trust beneficiaries as the cornerstone of the organization.

The 1994 Settlement Agreement came about after litigation between beneficiaries and the State over the previous management of Trust assets. At the conclusion of the settlement, the Trust had one million acres of land and a Trust fund of \$200 million invested with the Alaska Permanent Fund. These resources are held in a perpetual trust for current and future beneficiaries. An important goal for managing these resources is to generate income, which can then be used to support a comprehensive mental health program for Alaska. Trustees have continued that original vision of carefully shepherding Trust resources for the long-term benefit of beneficiaries. *Through diligent efforts and careful decision making, that \$200 million has grown to a total asset base of \$668 million. During the same period the Trust has distributed approximately \$300 million to support beneficiary programs and services.*

As trustees consider decisions about investments, expenditures, and other key governance factors they are guided by state and federal law (including generally applicable trust law), state regulations, and a body of historic communications between the settlement participants and other stakeholders that are incorporated into the Settlement Agreement. Some of this material is silent on key components of Trust operations, some of it may be considered contradictory, and some is ambiguous. Therefore, trustees do their best to diligently interpret this complex body of law and policy, to understand the legislative intent at the time that the Settlement was enacted, and most importantly, they work to fulfill their duty as trustees by making decisions that are in the best interest of the beneficiaries.

The audit report accurately portrays the same spirit of service that motivates trustee decisions as well as the daily actions of Trust management and staff, as noted on page i of the audit report. In the context of the report, it is important to consider both the information presented by the audit team as well as the background information and context that may not be easily available to the reader of the report. The audit examined Trust activities from 2008 through 2017, a period that includes a time of unprecedented world-wide financial turmoil, a collapse of the US housing market, as well as the bankruptcy and collapse of iconic American institutions. This volatility led to multi-million dollar losses in the Alaska Permanent Fund. Since the Mental Health Trust Fund is held as an undivided portion of the Permanent Fund, the Trust suffered the same losses.

Financial support for beneficiary programs rely on an annual distribution of 4.25% of the four-year average value of Trust investments. Because of the losses sustained in the collapse of the stock market 10 years ago, the Trust's ability to support beneficiaries at similar levels was in question and trustees acted to secure a diversified and stable source of spendable income for the Trust. The tool that they selected was a portfolio of seven high quality, well managed, and conservatively positioned commercial real estate assets. These buildings are leased to a mix of federal, state, and commercial tenants and generate stable and predictable income. For perspective, the amount of capital invested in these buildings is approximately 6% of Trust assets. Further, they are in an asset class that dampens the daily up and down swings of the financial markets.

**Response to Recommendation One:**

The report recommends that the Trust stop investing in commercial real estate, consult with the Alaska Permanent Fund Corporation on existing commercial real estate, and transfer the existing cash principal balance from the Trust Authority Development Account to the Alaska Permanent Fund Corporation. This recommendation is based on the conclusion that plain language in statutes prohibits this investment strategy. However, the audit report does not recognize the other legal requirements and obligations that are required of the Trust. When viewed in total, the Trust has acted reasonably.

*We respectfully disagree with the report's conclusion about the legality and propriety of the Trust's commercial real estate investments.* We maintain the position that these decisions were not a diversion of money from the Trust; they were legitimate management decisions to invest funds in an alternative investment for the benefit of the beneficiaries. The Trust's investment strategy and individual investment decisions were made in dozens of public meetings. The Trust's investment decisions were authorized by and consistent with applicable regulations and legal advice. The Trust's actions were also subject to the oversight of third-party external auditors. Beneficiaries, both as individuals and through their advisory board representatives, as well as the general public and community stakeholders, were all provided opportunities to testify and comment on Trust actions.

However, we recognize that the legal framework could be significantly clearer regarding these investments. As a result, the Trust will take the following actions:

- Make no further real estate investments at this time.
- Work with the Alaska Permanent Fund Corporation (APFC) to evaluate the possible transfer of the existing real estate assets to the APFC.
- Continue to consider additional transfers of investable cash to the APFC (\$10 million has been transferred in the last six months).

- **Work with Trust stakeholders to develop forward-looking guidance for Trust investment subject to legislative and judicial review.**

***Furthermore, the Trust's commercial real estate investments have been very successful. The underlying values of the investments have increased and they have generated more income for beneficiary programs than a similar transfer from the Trust investment portfolio at the Permanent Fund would have generated.*** The real estate portfolio has distributed \$6.03 million since inception. The same investment of principal, using historic investment results from the Permanent Fund and applying the Trust's 4.25% distribution rate, would have generated \$3.26 million. The Trust's actions have not harmed the Trust and its beneficiaries and the investments produced more favorable results than the investment option recommended in the audit report.

**Response to Recommendation Two:**

Separate from commercial real estate investments, the Trust has invested in Alaska properties to support service delivery to beneficiaries. These are identified as Program Related Investments (PRI) and these assets provide in-kind support for beneficiary programs beyond the financial grants made by the Trust. These investments are strategic assets of the Trust—they are platforms for beneficiaries to receive services as well as a place of stability in the communities that the Trust serves. Most of the Trust's current PRIs are facilities and/or land the Trust received during the reconstitution of the Land Trust and were already being used by Trust providers like the ARC of Anchorage, Assets, Inc, Catholic Social Services, and others. In other cases, like the Fairbanks detox facility, the Trust invested in land or facilities that also support an important Trust service. These assets have been acquired and improved with the use of Trust principal and are intended for the long-term benefit of the beneficiaries. The funding mechanism around making new Program Related Investments is very similar to the commercial real estate investments: the Trust generates principal through the sale of assets (land, coal, etc.) and uses that principal to subsequently acquire and improve property for PRI purposes.

The report recommends that trustees fund future Program Related Investments from Trust income and transfer an additional \$2 million out of Trust income to the Permanent Fund to replace funds used for these investments. This is a source of significant concern. Given the state's limited capital budget the Trust is frequently approached by community health clinics, government agencies, and other providers to help meet needs for capital improvements. ***Given the current economic climate, the Trust needs to be able to bring all available resources forward to help meet these needs. A decision to restrict the funding to just the use of Trust income creates a significant barrier for communities to get help meeting their capital project needs. The Trust will respond to this recommendation in the same manner as Recommendation One. Since the recommendation would likely lead to less available resources for beneficiaries, the Trust must carefully consider all available options. In the meantime, no further principal investment funds will be allocated to PRI projects.***

**Response to Recommendation Three:**

All of the Trust resources, including the land and financial assets, are managed in accordance with a Resource Management Strategy (RMS) and an Asset Management Policy Statement (AMPS). These documents were developed in a public process. These documents are subject to revision as new information becomes available and the Trust becomes aware of new opportunities. ***The Trust completely agrees with the report recommendation that the AMPS & RMS be reviewed and, if needed,***

*amended to reflect the best practices in investment management and any changes to state investment law. The Trust is always looking to better serve the beneficiaries and taking this step will help us ensure that their interests are protected.* We anticipate completing this work by June 30, 2019.

**Response to Recommendation Four:**

Since the audit began the Trust has made significant organizational and personnel changes. The Trust has a new chief executive officer, chief financial officer, and executive director of the Trust Land Office. Oversight of programmatic activities as well as land office operations has been consolidated under the chief executive officer creating a unified line of authority. The Trust has also elected a new board chair, seated two new trustees, revised the Trust bylaws, updated job descriptions for officers, and implemented new charters for trustee committees. The audit report raises specific concerns about adherence to open meetings requirements, appropriate notice for trustee meetings, the need for adequate minute taking to capture trustee business decisions, conflict of interest declarations, and other elements associated with the proper conduct of trustee meetings and makes recommendations to correct deficiencies in these areas. *The Trust completely agrees with the report recommendations and in addition to the governance changes has already established training programs to ensure trustees, management, and staff are familiar with all relevant compliance requirements. We anticipate that this work will be an ongoing effort of the Trust and we will continually seek excellence in this area.*

**Conclusion:**

For over 20 years, the Trust has advocated in the best interests of beneficiaries, provided direct support to beneficiaries and helped to create positive systems change to improve health care access and the quality of life for beneficiaries. Trustees remain deeply sensitive to the needs of our beneficiaries, the State, local, and tribal government partners, as well as our community non-profit organizations across Alaska. The trustees, management, and staff are committed to managing Trust resources and conducting Trust business in a manner that upholds the highest standards of conduct and protects public trust in the institution.

Our statutory advisory boards include the Alaska Mental Health Board, Advisory Board on Alcoholism and Drug Abuse, Governor's Council on Disability and Special education, and Alaska Commission on Aging. These groups share our interest in serving the approximately one out of ten Alaskans that qualify as a beneficiary. The Trust considers the audit report recommendations to be an opportunity to review all of the elements of Trust operations and to make any necessary improvements to the organization. Such improvements will help ensure the Trust is positioned to advocate and serve beneficiaries in perpetuity. Thank you for your efforts and the hard work of the audit team in completing the audit report, we appreciate your interest in the Trust and how jointly we can meet the needs of the beneficiaries and the people of Alaska.

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# Legislative Auditor's Additional Comments

## ALASKA STATE LEGISLATURE LEGISLATIVE BUDGET AND AUDIT COMMITTEE Division of Legislative Audit



P.O. Box 113300  
Juneau, AK 99811-3300  
(907) 465-3830  
FAX (907) 465-2347  
legaudit@akleg.gov

May 10, 2018

Members of the Legislative Budget  
and Audit Committee:

We have reviewed the responses to the audit report from the Alaska Mental Health Trust Authority (Authority), Department of Natural Resources (DNR), Department of Revenue, and Office of the Governor. Nothing contained in the responses causes us to revise or reconsider the report conclusions and recommendations. Responses to the audit from the Authority and DNR include statements that are inconsistent with the audit's conclusions. We offer the following comments to address these statements.

On page two of the Authority's response, the Authority's chairperson dismisses the audit's conclusions regarding the illegality of the Authority's actions by stating "the audit report does not recognize the other legal requirements and obligations that are required of the Trust. When viewed in total, the Trust acted reasonably." This statement and the statements that follow fail to address the Authority's actions in light of the settlement. Consequently, we found no basis upon which to reconsider our conclusions and recommendation.

On page two of the Authority's response, the Authority's chairperson contends that the "Trust's investment choices were authorized by and consistent with applicable regulations and legal advice." In contrast to this statement, the audit concludes that regulations allowing the Authority to use Trust cash principal for commercial real estate investments through the TLO violate statutes. As such, the regulations are not a suitable justification for the diversion of Trust principal. In regard to the Authority's assertion that investments were made consistent with legal advice, the Authority's board of trustees, citing attorney client privilege, refused to provide auditors with the Authority's legal guidance that was available to trustees at the time commercial real estate investment decisions were made. Accordingly, the degree to which trustees acted in accordance with legal guidance or the degree to which trustees acted contrary to legal guidance could not be determined by auditors.

Furthermore, on page two of the Authority's response, the chairperson states that "the Trust's actions were also subject to the oversight of third-party external auditors." This statement is

not accurate, as external financial auditors only opined on the presentation of the Authority's financial activity, not on whether Trust actions were allowable by state law or terms of the settlement.

On page two of DNR's response, the commissioner states that the audit report "does not adequately distinguish between actions that are solely investment actions that involve commercial real estate investments, which it concludes TLO [Trust Land Office] should not handle, and TLO's management decisions regarding the trust's land corpus." We disagree with this statement. Page 18 of the audit report states "The audit concluded that while the TLO is authorized to manage the in-state land allotted to the Trust as a part of the settlement, the TLO is not authorized to manage a national commercial real estate investment program."

On page 3 of DNR's response, the commissioner disagrees with the audit's conclusion that TLO's management of the commercial real estate investments inflated Trust's costs. The commissioner states:

*The report assumes that the TLO has no need for real estate staff with real estate expertise if the TLO is not involved with a real estate investment program. That is simply incorrect. Whether or not the TLO is managing the real estate investment properties, it still has a statutory and fiduciary obligation to manage the trust's other existing buildings and commercial real estate within the original trust land portfolio. Accordingly, only a portion of management costs have been associated with the real estate investments.*

We disagree with the commissioner's characterization of the audit's conclusion. The audit describes, on page 34, the specific portion of personal services that could have been avoided if the Alaska Permanent Fund Corporation (APFC) performed the real estate investment function. The audit also explains that because the APFC invests on a much larger scale than TLO, the transaction costs would likely have been less.

In summary, we reaffirm the audit conclusions and recommendations.

Additionally, there are two exhibits in the audit which have incorrect source labels. The source for Exhibit 15 on page 51 should read "Source: TLO files." The source for Exhibit A on page 70 should read "Source: Open Meetings Act."

Sincerely,



Kris Curtis, CPA, CISA  
Legislative Auditor