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ISTA fund showed many trades, big losses

Investigation found broker's pay rose as assets withered

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An investment broker hired by the state teachers union insurance fund made an extraordinarily high number of trades and received a large increase in his commissions even as the fund's assets were plummeting, according to a report obtained Friday by The Indianapolis Star.

Both the FBI and the Securities Division of Secretary of State Todd Rokita's office are investigating the handling of investments in the Indiana State Teachers Association's Insurance Trust, sources close to the investigations said.

Warren L. Williams, ISTA's former executive director, and Morgan Stanley investment broker David Karandos worked in tandem to trade millions of dollars in high-risk hedge funds and private equities in the trust's accounts, according to the report.

It was prepared by Indianapolis-based Noble Consulting Services, which was hired by state regulators to analyze ISTA's insurance trust. The trust covers long-term disability benefits to teachers in 90 of the state's nearly 300 school corporations and health insurance in 30 districts.

In their report, Noble's consultants noted that:

>> Over nine months in 2008, more than 4,000 investment trades were made, "an extremely high volume for a portfolio of this size."

>> "Despite large losses in the portfolio," Williams approved a 50 percent fee increase for Karandos.

>> In addition to receiving overall fees for his work, Karandos also charged full commissions in a sample of trades analyzed by Noble.

>> Williams and Karandos controlled all investments. Williams, who resigned Thursday, could not be reached for comment Friday. Karandos, who works in Morgan Stanley's Carmel office, declined comment.

ISTA Deputy Director Dan Clark, who had no role in the trust's investment, said he had "no reason to doubt the conclusions of the report."

Fund near bankruptcy

The FBI and Rokita have declined to say whether they are investigating.

Indiana Department of Insurance Commissioner Jim Atterholt declined to discuss the report Friday, and Randy Lamberjack, president of Noble Consulting, could not be reached. Noble was hired to help broker a deal for ISTA to transfer its health insurance plan to a new carrier, but in the process found an insurance fund on the verge of bankruptcy with a projected $67 million deficit.

If the self-insured fund goes bankrupt, school districts -- and taxpayers -- would be left to pick up the tab, which state regulators have said could be substantial.

Most of the fund's woes were attributed by the consultants to an unusually high percentage of investments in high-risk equities that are not publicly traded. Of the fund's $19 million in assets, the report showed $16.4 million was invested in private equities and $1.7 million in hedge funds.

The report observed that the fund "lost more than the comparable average portfolio over the past three years" and called the investment mix "inappropriate for health insurance portfolios."

Karandos currently works for Morgan Stanley but also made trades for ISTA as an investment manager for UBS Financial Services. Clark said Karandos has served as the fund's investment manager for at least 10 years.

Allison Chin-Leong, a spokeswoman for UBS, confirmed Karandos worked there from May 2003 until March 2008, but declined to comment further.

Christine Pollak, a spokeswoman for Morgan Stanley, said Karandos has worked there since February 2008 and transferred the ISTA investments with him when he switched companies. She said Morgan Stanley will cooperate with investigations but declined to discuss Karandos' work.

Noble's report not only raised concerns about the type of investments Karandos and his hired managers made, but how frequently he charged fees for his work -- including the 50 percent increase last year when the fund's assets were dropping.

The report said Karandos charged a "full-service management fee," which usually comes in one of two forms -- either a flat payment or a percentage of investment returns.

In addition to that overall fee, a sample of larger trades reviewed by Noble showed Karandos received full commissions for those trades on top of his overall fee. The eight submanagers he hired also received fees, the report said.

Bradley Skolnik, a securities lawyer who once worked as commissioner of the same state securities unit investigating the ISTA fund, said the 50 percent increase should raise "a red flag."

He said making more than 4,000 trades over a nine-month period will raise interest from investigators of "churning," a practice in which a large number of trades are made to maximize the profit investment managers can make.

Chip Snively, co-director of the Investment Management Academy at Indiana University's Kelley School of Business, also said the number of trades appears to be very high.

"If you had $19 million -- or even $100 million -- in individual shares of stock, it would be tough to come up with 4,000 trades," Snively said.

Scope of the probe

Skolnik said investigations by the FBI and secretary of state likely would focus on potential violations of state and federal securities laws. Penalties in such cases could range from sanctions such as the suspension of a state license to criminal charges, Skolnik said.

Rokita's office, he said, would be limited to violations of state securities law, while the FBI's probe could be wider.

Investigation into securities law violations could range from misrepresenting investment products and excessive trades to a broker's responsibility to recommend suitable investments for their customer's needs.

Another possible area of inquiry: whether information was withheld from the board that oversees the fund.

Clark said ISTA is working to determine how informed its board members were of the fund's investments.

"It's my understanding that (Williams and Karandos) reported information to the boards," he said, "but there are some issues about how well all of the information was explained."

Meanwhile, ISTA is searching for a financial solution.

The eight members of the ISTA board of trustees, which oversees the insurance trust, met Friday night with attorneys to review subpoenas they have received from Rokita's office, Clark said. Williams and the fund's former executive director, Robert Frankel, who was not named in the state report, also have received subpoenas, Clark said.

The ISTA board of directors, which oversees the union, will meet today to consider options for ensuring the insurance trust remains solvent, Clark said.

"We're responsible, and we will be judged by how well we fix the problem," Clark said. "We hope next week to announce a solution that will guarantee that no one will go unpaid."

Even if the fund is saved, damage has been done, Snively said.

"This does harm beyond this fund and the people covered under it," he said. "This has put a crack in the public trust."

Additional Facts

THE FINDINGS

Highlights from Noble Consulting Services' report to the Indiana Department of Insurance:
» More than 4,000 investment trades were made during nine months in 2008, which the report called "an extremely high volume for a portfolio of this size."
» A 50 percent raise was OK'd for investment broker David Karandos, despite "large losses in the portfolio and overall poor performance."
» Multiple commissions were paid to money managers. Karandos received not only a flat, overall fee but commissions on trades. Eight submanagers also received fees.
» Control of investments rested with Karandos and former ISTA Executive Director Warren L. Williams.

THE INVESTIGATIONS
Violations of state and federal securities laws could include the following:
» Misrepresentation of investment product to the customer, or in the ISTA case, whether its boards were properly informed of the nature of the investments.
» Excessive trading in the fund where money managers attempt to maximize commissions and fees.
» Suitability of the investments. Money managers have a professional responsibility to recommend investments that are appropriate for the customer's financial goals.
» Registration of the investments. With a few exceptions, most investment products must be registered within the state where they are offered.