HALE LANE
ATTORNEYS AT LAW
777 East William Street | Suite 200 | Carson City, Nevada 89701
Telephone (775) 684-6000 | Facsimile (775) 684-6001
www.halelane.com

SCOTT SCHERER
sscherer@halelane.com
Direct: (775) 684-6011

September 10, 2007

Lieutenant John Drew
Nevada Division of Investigation
555 Wright Way
Carson City, NV 89711

Dear Lieutenant Drew:

We are writing concerning your investigation of the unfounded allegations that have been made against Brian Krolicki. With this letter and the attachments, we hope to provide you and your staff with additional information that will be useful to you in conducting and completing your investigation. If there is additional information you require with which we might be able to assist, please do not hesitate to contact us.

We thoroughly reviewed the May 14, 2007 audit report of the Legislative Counsel Bureau ("LCB"). We believe the most important point the audit makes is that every penny was accounted for and all funds spent went toward the college savings program. It is unfortunate, however, that the LCB labeled its report an "audit" because people expect an audit to be complete, accurate and conducted by independent certified public accountants. Our client has no doubt that the LCB staff is competent, but the LCB is not independent of the Legislature and the report contains numerous errors and omissions. The report was obviously prepared under time pressure due to the end of the legislative session, and we would respectfully suggest that your office take all this into account and view the report as an interesting but flawed document. On behalf of our client, we believe it is prudent at this time to comment on four of the errors and omissions in the report.

1. One important omission from the report goes to the heart of the investigation requested in Mr. Krolicki's letter of March 12, 2007 to Attorney General Cortez-Masto. In that letter, he requested a review of the Upromise payments and the state payments to the Rose/Glenn Group (attached hereto as Exhibit A). The LCB did not audit the books of Upromise or Rose/Glenn to determine whether state funds or Upromise funds were or should have been used to pay the Rose/Glenn Group. In addition to the standard state contract audit provisions, the Board of Trustees of the College Savings Plans of Nevada ("Board of Trustees") required extensive audit provisions in the Upromise contract (attached hereto as Exhibit B)) because Upromise was to receive, hold and disburse funds on behalf of the state. Please see Section 5.4 of the Direct Program Management Agreement in addition to Section

8 of the contract with Upromise. There is no doubt that the state has the right to audit Upromise's books and the books of the Rose/Glenn Group. The LCB's failure to do so is a glaring omission in its report.

Section 10.3(c) of the Upromise contract required "an annual marketing budget incorporating both marketing efforts by UII and marketing of the Upromise Service in the State." Upromise Contract, § 10.3(c). "During the first twelve months, UII, Upromise and its Contributing Companies will provide an aggregate of at least $700,000 in value of marketing related to the Direct Program and the Upromise Service in the State and annually thereafter an aggregate of at least $500,000 in value." *Id.*

Under the initial contract, Upromise was obligated to spend a total of $1.7 million under Section 10.3 through February 2005, and $500,000 more through February 2006 to provide marketing of the program which "may include, in the best judgment of Upromise Investments, Inc. ("UII") and the Board, any or all of the following: (i) advertisements by means of direct mail, radio, television, Internet, or any other medium; (ii) education of the public and the financial press through press releases, seminars, informational brochures, etc.; and (iii) such other activities as UII and the Board may deem advisable." Upromise Contract, § 10.3(b).

Throughout our client's tenure as State Treasurer, he believed that UII was paying the Rose/Glenn Group for direct mail and television advertisements as part of its contractual obligation to fund marketing activities. That belief was supported by a document prepared by Janice Wright, the contract administrator and Senior Deputy Treasurer responsible for the Plans during Mr. Krolicki's tenure and at the beginning of the new Treasurer's Administration. The document is a spread sheet entitled "529 Actual Marketing Expenses" and shows the amount of state funds spent on marketing activities conducted by Rose/Glenn on behalf of the Plans (Exhibit D). As you will see, the spread sheet, prepared July 10, 2006, shows that the state funds spent on marketing the Plans were within the limits of legislative authority for each fiscal year in which the Plans were operated. Rose/Glenn obviously shared the belief that UII was paying for its contractually obligated marketing expenses directly since it maintained separate accounts showing the amounts paid out of state funds and the amounts paid by UII.

A September 2005 amendment of the Upromise contract (the "September 2005 Amendment"), however, included an unconditional waiver of any claim that Upromise did not fulfill its marketing commitments in Section 10.3 of the Upromise contract and also deleted Section 10.3 in its entirety (Exhibit C). The September 2005 Amendment consisted of a few lines out of a long document that was submitted to our client and the other members of the Board of Trustees for approval. Neither Senior Deputy Treasurer Wright, nor the deputy attorney general who reviewed and approved the amendment explained its implications or importance.

Ms. Wright is a very experienced state official. She was, therefore, well-qualified to be the exclusive staff member from the State Treasurer's Office assigned to manage the daily

activities of the college savings program and to perform all work related to the activities of the Board of Trustees. Ms. Wright was also solely responsible for all requests for proposals, contracts, and billings related to services rendered under each contract. She established the agendas for all Board meetings, and compiled and distributed all information packets to Board members. She taped the meetings, put together Board minutes and was directly responsible for retaining all pertinent information related to these meetings.

As you may know, Ms. Wright has 30 years of state experience and has been recognized by the state of Nevada as a Certified Contract Compliance Monitor and a Certified Public Manager. To become certified as a Certified State Contract Manager, the Senior Deputy Treasurer was required to take a comprehensive class that covers:

> all aspects of public contract law in Nevada; focusing on procurements under the State Purchasing Act (NRS 333) and relevant provisions of the Nevada Revised Statues, Nevada Administrative Code and State Administrative Manual protocols. Topics for the first day of the course include: ethics, the Request for Proposals process and use of the informal bid process. The second day of the class addresses cost and price analysis, negotiations, and performance requirements, insurance and use of the Attorney General's Model Contract Forms. The third day of the class covers contract management and use of the Purchasing Division's vendor database and rating system. Attendance at all classes and the passing of a written test will be required to become certified.

State Department of Administration, Purchasing Division, "Certification for State Contract Managers", http://purchasing.state.nv.us/pur_info/agen_3.htm.

Senior Deputy Treasurer Wright chose to rely solely on the Attorney General's Office to review the September 2005 Amendment and did not use the outside law firm that was most familiar with the state's relationship with UII. Mr. Krolicki can only assume that this was due to the fact that UII convinced her that this was a routine amendment. The July 10, 2006 spreadsheet seems to indicate that she was not aware of the amendment to UII's marketing obligations. Our client has no idea why Senior Deputy Treasurer Wright and the deputy attorney general who reviewed and signed off on the September 2005 Amendment did not inform the Board of Trustees that the September 2005 Amendment did more than simply change the amount and basis of UII's fees, which was his understanding of the purpose of the September 2005 Amendment.

2. The LCB report erroneously alleged that our client, the people working for him in the Treasurer's office, and the Board of Trustees of the Nevada College Savings Program broke three state laws. Since the Treasurer's office works closely with the Attorney General's office and a deputy attorney general attends all meetings of the Board of Trustees and reviews and signs off on all contracts and contract amendments, it is clear that the LCB staff has a different interpretation of the laws in question than the people responsible for administering the laws. Apparently the LCB is not aware of, or chose to ignore, the long-standing view of the Nevada Supreme Court, expressed in many opinions, to the effect that

the interpretation placed upon laws by the administrative officers and agencies charged with that responsibility has great weight. One of the key omissions in the audit report is a failure to recognize and explain that the LCB's interpretation of those laws is not necessarily correct. Mr. Krolicki spoke to the Board of Trustees about this issue and a copy of his letter to them dated May 31, 2007 is attached to this letter as Exhibit E and explains why the laws cited by the report were not broken.

3. Another error in the LCB report is that it contends that payments made for the state by Strong and Upromise from state funds held by them were unusual and thus unlawful. The LCB report omits to state that such payments are common and authorized by state contracts. Each of the payments cited were made pursuant to contracts that were reviewed and approved by the Deputy Attorney General assigned to the Treasurer's Office, the Deputy Attorney General assigned to the Board of Examiners, and the Board of Examiners itself (which, of course, includes the Attorney General). There are numerous other examples of similar arrangements where contractors are paid out of the proceeds of a particular program. In connection with bond sales, the state frequently has the underwriter of the bonds pay expenses for and on behalf of the state. For example, in the August 2006 financing for the improvements to the LCB's own building, the underwriter's compensation and certain other expenses of the financing (including $242,000 for municipal bond insurance premium costs payable by the state) were paid by the underwriter and deducted from the amount paid to the state at the closing. This is the custom and practice in Nevada and elsewhere when municipal securities are sold. Underwriters typically pay some of the expenses for the issuer of the securities from money due the issuer. This procedure was followed in connection with the sale of college savings plan interests (which are securities) by Upromise and Strong. The underwriters (Upromise and Strong) paid expenses of the state from the proceeds of sale of college savings plan interests. The expenses included compensation of the plan's financial advisor (GIF Services), advertising expenses incurred in selling the securities (Rose/Glenn) and legal fees (Orrick, Herrington).

   Separately, the state's banking service fees are paid, pursuant to properly authorized contracts, with earnings derived from compensating balances on the funds deposited with those banking institutions. For example, the Treasurer's Office pays approximately $50,000 per month to the primary banking services provider (Bank of America), yet these fees are neither legislatively budgeted nor accounted for in the state's accounting system. See Exhibit F.

   Indeed, legal affirmation by the Attorney General's Office of these previously cited examples was given in June (and after release of the LCB Audit report) when the State Board of Finance approved contracts to pay bond counsel and financial advisors out of bond proceeds (Exhibit G). State Board of Finance Meeting (June 14, 2007). The Board of Examiners subsequently approved these contracts.

   Accepting the interpretation of the LCB Audit Division would severely disrupt the way that various contracts have been approved and interpreted for years, without any formal action by the Legislature to change the historic practice and interpretation. *See, Exhibit H e.g.,* Op.

Nev. Atty. Gen. No. 96-31, p. 10 (Nov. 4, 1996) (stating that a Legislative Counsel Bureau opinion "failed to recognize that the majority of NDOT's reliance on the legality of its practice concerning the processing of its contracts is based on the numerous statutes within Chapter 408 which provide the NDOT Board and Director with extremely broad authority with respect to independent contracts.") As a member of the NDOT Board, this opinion is of the utmost importance as to how our client fulfills his statutory duties.

Similarly, in this case, Chapter 353B gives the Board of Trustees and the Treasurer extremely broad authority with respect to contracting for services to the Plans (Exhibit I). The LCB Audit report glosses over the authority granted in Chapter 353B which is similar to the authority granted to NDOT under Chapter 408 of NRS. "This would nullify a large number of statutes ... contrary to the rules of construction." *Id.* at 11. "This would also nullify the historical interpretation by practice of NDOT and the Department of Administration. Moreover, the fact that the legislature had the opportunity to amend the statute to change this historical interpretation and practice is indicative of an intent to reject the idea of a change." *Id.* (citing *McKay v. Board of County Comm'rs of Douglas County,* 103 Nev. 490, 492 n.2, 746 P.2d 124, 125 n.2 (1987)).

4. Another error in the audit report has to do with accounting for state funds. The audit report verifies and acknowledges that no money is missing. The audit report fails to explain, however, that the accounting structure for the program was dictated by state law and the interpretation of state law by the State Controller. The Treasurer's Office was complying with applicable law, not breaking the law.

   At the outset of the program, it was the Treasurer's Office intent that all funds would be accounted for in a single Trust Fund. The Treasurer's Office was prohibited, however, from doing so by the State Controller's Office. In discussions with the LCB auditors, they stated that our client had correctly established this program as a "Private Purpose Trust Fund" in 2001. However, the State Controller's Office determined in 2002 that there was no need to have this Trust Fund and eliminated it. (See Legislative Audit Report, page 33.) The State Controller's Office told Treasurer's Office staff that the Trust Fund was eliminated according to its interpretation of Governmental Accounting Standards Board (GASB) Rules, which have the force of law.

   The program was therefore functionally folded into the General Fund, essentially causing only the revenues derived from the program fees to fund the 1092 budget account. All other financial related information was compiled and managed by the Senior Deputy Treasurer under state contracts and outside the 1092 budget account. The accounting architecture no longer existed in the Capitol Complex to fully reflect the various components of the program in a single account. In short, the original way the program was established by the State Treasurer's Office in 2001 was structured the way the auditors want it done today. However, in 2002 the State Controller's Office moved the program outside of the state system, citing applicable law.

Our client was pleased that the audit report noted his office's continuing efforts to improve the accounting system for the program, recognizing that in November 2006, before the LCB Audit had even been requested, the Board of Trustees, at the request of the Treasurer's Office, took steps to provide more comprehensive accounting of all of the funds collected and spent by the Plans. (See Legislative Audit Report, page 29.) These changes were noted as positive changes by the auditors and were enabled by the renegotiation of terminated or expired contracts related to work in the "start-up" phase of the program.

We note that the LCB is prohibited by NRS 218.635 from continuing the investigation that produced the report. Providing this information to LCB, therefore, would not further the cause of determining the issues raised by the report. We have provided this information to you in the hope that it will be of use to your office in the course of its investigation.

The bottom-line is that no money is missing, no laws have been broken, and everyone who worked on creating and developing this highly successful College Savings Program (including the various deputy attorneys general) have good reason to be proud of what they collectively accomplished and the manner in which they did so. As the LCB Audit noted, Nevada's College Savings Program is one of the most successful college savings plans in the country.

Regrettably, differing interpretations of conflicting statutes exist between the legislative and the executive branches, and this tension has been exacerbated by the fact that the LCB Audit is a hurried and incomplete review of the applicable laws and facts. There can be no disagreement, however, that the Treasurer's Office and the Board of Trustees acted pursuant to contracts approved by the Attorney General's Office and the Board of Examiners and in accordance with historical practice.

Our client offers you his assistance in this effort in any way that may be helpful, and looks forward to your thorough and complete review of the law and the facts.

Best regards,

Scott Scherer
Hale Lane Peek Denison and Howard

Kent Robison
Robison, Belaustegui, Sharp & Low