

STATE OF WISCONSIN

CIRCUIT COURT

DANE COUNTY

2012 SEP 14 AM 9:11

WISCONSIN DEPARTMENT OF
FINANCIAL INSTITUTIONS,

DANE CO. CIRCUIT COURT

Plaintiff,

v.

Case No. 12CX44

WISCONSIN FUNERAL DIRECTORS
ASSOCIATION, INC.,

and

FIDUCIARY PARTNERS, INC.,

Defendants.

THIS IS AN AUTHENTICATED COPY OF THE
ORIGINAL DOCUMENT FILED WITH THE DANE
COUNTY CLERK OF CIRCUIT COURT.

CARLO ESCOBEDA
CLERK OF CIRCUIT COURT

AFFIDAVIT OF SCOTT O. CONWELL

State of Wisconsin)
)
County of Dane)

Scott O. Conwell, being duly sworn, deposes and states:

1. I am a resident of the State of Wisconsin and am over the age of eighteen (18) years. I make this affidavit in support of the Wisconsin Department of Financial Institutions' petition for injunctive relief and appointment of a receiver.

2. I am employed as an Advanced Securities Examiner by the State of Wisconsin, Department of Financial Institutions, Division of Securities ("the Division"). I am responsible for leading or individually conducting comprehensive examinations of alleged violations of the Wisconsin Uniform Securities Law, performing forensic accounting, and assisting Division attorneys with administrative and judicial proceedings.

3. I have been employed in the securities industries for twelve years and have held various positions including financial planner, investment consultant, Director of Planning/Financial Representative, and Supervisory Controls Principal where I was in charge of investigating, auditing, and implementing a firm's compliance with regulatory requirements. The designations I currently hold include Certified Financial Planner, Chartered Financial Consultant, and Chartered Life Underwriter.

4. As part of my usual and customary duties as a securities examiner, I was assigned to investigate the Wisconsin Funeral Trust ("Trust") to determine its compliance with the Wisconsin Uniform Securities Law. This affidavit details the findings of the Division's investigation.

5. The Division's investigation included personal interviews of the Wisconsin Funeral Directors Association ("WFDA") Executive Director Scott Peterson, the WFDA general counsel Scott Gilligan, other WFDA representatives, and representatives from the corporate trustee Fiduciary Partners, Inc., an investment advisor representative to the Trust, and their legal counsel. The WFDA also provided written responses to the Division's inquiries. The Division obtained from the Association and trustee a large number of documents, including the agreement forming the Trust, minutes from meetings of the committee charged with overseeing management of the Trust, reports from the Trust's investment advisors, including details on the makeup and performance of the Trust's portfolio, marketing materials produced for the Trust, administrative materials used and distributed by the Trust, audited financial statements, and other documentation of the Trust's operations and activities. The factual details discussed below were derived from my personal interviews of the above-noted individuals, their written responses to

questions I directed to them, and my review and analysis of the information and documents provided to the Division.

6. The Trust was conceived on or about March 29, 1999, when the Association entered into a "Trust Agreement Establishing the Wisconsin Funeral Trust" (hereafter "Trust Agreement") along with a trustee, the Stephenson National Bank & Trust. Attached as Exhibit A to this affidavit is a true and correct copy of the Trust Agreement.

7. Notably, the Trust Agreement does not define any beneficiaries of the Trust and states that the Association "shall own, sponsor, and endorse the Wisconsin Funeral Trust..." (Ex. A, p. 7).

8. The Trust Agreement has been amended four times, beginning in 2002. Attached as Exhibit B are true and correct copies of the Amendments to the Trust Agreement. These amendments removed restraints upon the investment of Trust assets. The Trustee was also stripped of authority to select the investments and is now required to follow the directives of the Association and/or its investment advisor. As a result of this series of amendments, the Trustee must implement the investment decisions of the Association or investment advisor, and invest the assets in any way "authorized under the Wisconsin Uniform Prudent Investor Act."

9. During its investigation, the Division became aware that there is a state statute not administered by the Department of Financial Institutions that applies to burial agreements funded by trusts. Wis. Stat. § 445.125(1)(b)(1) states that:

All trust funds under par. (a) shall be deposited with a bank or trust company within the state whose deposits are insured by the federal deposit insurance corporation, deposited in a savings and loan association or savings bank within the state whose deposits are insured by the federal deposit insurance corporation, or invested in a credit union within the state whose savings are insured by the national board, as defined in s. 186.01 (3m), and shall be held in a separate account in the name of the depositor, in trust for the beneficiary until the trust fund is released under either of the conditions provided in par. (a) 1.

10. I understand Wis. Stat. § 445.125(1)(b)(1) to require that funeral trust funds be held in the form of a deposit with a bank or trust company in Wisconsin whose deposits are insured by the FDIC or a national credit union board with similar government insurance, and that the funds must be held in trust in a separate account in the name of the depositor. However, the Division learned that this requirement was never followed during the Trust's existence, as the Trust funds have always held investments other than deposit accounts, and the funds of all investors are commingled in one fund and not held in separate accounts. The investor "account" values, representing their pro rata investment in the Trust, are tracked by the a third-party administrator called the Newport Group but there are no actual separate deposit accounts holding the funds collected from the investors.

11. The Trust implemented an Investment Policy Statement effective January 31, 1999 that established strict parameters for the investment of the Trust funds and prohibited certain investments entirely, including investment in equities, commodities and futures contracts, private placements, options, limited partnerships, real estate, and CMO's (collateralized mortgage obligations). A true and correct copy of the 1999 Investment Policy Statement is attached as Exhibit C. This Investment Policy remained in effect until June 2012, when it was superseded by a new policy that substantially broadened the scope of allowable investments. The June 2012 Investment Policy Statement is attached as Exhibit D.

12. The Trust and the WFDA have employed the services of investment advisors Morgan Stanley Smith Barney, LLC (formerly called Smith Barney, Inc. Consulting Group and Citigroup Global Markets, Inc.), and bluepoint Investment Counsel, LLC. Investment advisor representatives Michael and Patrick Hull have managed the Trust's portfolio since its inception, first under Morgan Stanley Smith Barney and then under bluepoint, a new firm established by

the Hull brothers. Since 2006, the Hull brothers have had full discretionary authority to invest the Trust assets and only must send notification of their investment activity to the WFDA.

13. Attached as Exhibit E are the marketing brochures that the WFDA developed and provided to funeral directors to solicit investors. The brochures market the Trust as an “investment product” with a “very competitive rate of return” and the “premier investment option.” Investors are told that the Trust provides “high, safe, and secure rates of return,” that it “provides a competitive rate of return by pooling funds for investment purposes,” “meets all state and federal laws,” “has been approved by the Wisconsin Department of Financial Institutions,” and the trust investment portfolio consists of secure vehicles including: CD’s, Money Markets, Investment Grade Corporate Bonds and Government Bonds. Throughout the life of the Trust, its portfolio has at times contained no government bonds and almost no cash deposits.

14. Participation in the Trust is only sold through the WFDA’s member funeral directors. According to the April 6, 2006 Preneed Committee Meeting minutes furnished by the WFDA to the Division, a true and correct copy of which is attached as Exhibit F, this restriction is in place because the Trust is owned by WFDA and is a member benefit.

15. The funeral directors are incentivized to sell investments in the Trust because they lock in future business with a Preneed Funeral Contract. Clients commence participation in the Trust by signing a “Wisconsin Funeral Trust Preneed Funeral Contract” with a participating funeral home. Preneed contracts are used in the funeral industry to allow funeral clients to make advanced arrangements for their burial needs, with the fees for the funeral services held in “trust” and then paid out to the funeral home upon the client’s death.

16. The WFDA provides its funeral directors with all marketing and contractual materials for selling “pre-need” contracts and procuring investments in the Trust.

17. The funeral directors selling participation in the Trust are provided little information concerning the Trust, do not receive any formal training to sell the pre-need investments and are not licensed financial professionals. They are provided with a short “Administrative Manual” and a Directors’ Information Packet, true and correct copies of which are attached as Exhibit I. These materials do not provide any information concerning the Trust’s actual investment portfolio, the role of the Association and the revenues it draws from the Trust, or the risk of any losses to the invested funds. These materials misinform the funeral directors that the Trust complies with all state laws, has been approved by the Wisconsin Department of Financial Institutions and that the rate of return is set at 1% over the State of Wisconsin average of 3-year CDs.

18. The directors are not provided written or regular reports of the Trust’s investment performance or the investments that comprise the Trust’s portfolio. According to Mr. Peterson, the Executive Director for the WFDA, the association membership frequently asks about the portfolio, in which case they receive general information about the investment performance.

19. Under the contracts developed by the WFDA, investors in the Trust may select either a “Guaranteed” or a “Non-Guaranteed” contract with a funeral home. Under the “Guaranteed” option, the funeral home agrees to provide funeral services to the beneficiary of the contract at a price not to exceed the balance of the trust account at the time the funeral is provided. Under the “Non-Guaranteed” option, by contrast, the funeral home agrees to provide the funeral services at the cost of those items at the time of the funeral. Trust funds are invested to offset the price of the funeral, but if the cost exceeds the available trust funds, then the difference has to be made up, presumably by the heirs of the decedent. Attached as Exhibit G

are true and correct copies of the guaranteed and non-guaranteed contracts used by the WFDA and its funeral directors

20. Investors in the Trust can elect to make up to \$3,000 plus all income earned on the account irrevocable. This allows the investors to eliminate the \$3,000 and resulting income from being counted as the investor's assets for purposes of qualifying for Medicaid. The pre-need contracts attached in Exhibit G provide that, for persons who choose the "irrevocable" option, any initial contributions over \$3,000 are refundable upon demand. Persons who choose the "revocable" option may demand a refund of the entire amount of their investment and all accrued earnings, at any time.

21. Investor funds are made payable directly to the Trust but are collected by the funeral directors who forward the funds to the Trust for investment. Neither the directors nor the investors have any input in or authority over the investment of the Trust funds.

22. Nearly 500 funeral businesses and more than 10,500 investors currently have "pre-need" contracts tied to the Trust.

23. Upon receiving an investor's funds, the Trust issues a "Certificate of Deposit Receipt" to the investor, informing the investor that his/her funds are being held in a deposit account. The investor's funds are not actually deposited into an individual account but are instead commingled with funds from other investors in the Trust and invested in the Trust's portfolio. Attached as Exhibit H is a true and correct copy of a "Certificate of Deposit Receipt" issued by the Trust. The investor also receives a copy of the executed contract and a claim form. The investors receive no other communications about the Trust.

24. As an inducement to invest in the Trust, investors are guaranteed a rate of return of 1% more than the state average three-year CD rate. However, the rate of return being credited

to investor accounts and paid out under the pre-need contracts has always been set higher than 1% over the average. The WFDA uses what it calls a “crediting rate,” where a special pre-need committee meets every six months and determines a rate that will be used to credit investor accounts. The crediting rate has been consistently set in excess of 1% over the CD rate, irrespective of whether the Trust had sufficient funds to pay all of its investors as promised. The Trust investors are never informed of the actual crediting rate or the fact that the rate does not reflect that actual return of the Trust.

25. When an investor commences participation in the Trust, his or her respective funeral director designates the investment as a “Qualified Funeral Trust” for tax purposes, in which case taxable income attributed to the investor is paid by the Trust from the investor’s account. If the funeral director does not designate his or her investors as having a Qualified Funeral Trust, the Trust applies the crediting rate to the investor’s pro rata share of the Trust portfolio, reports that artificial gain to the Internal Revenue Service as income to the investor, and issues a Form 1099 to the investor to pay taxes on the gain attributed to the investor through the crediting rate process. Thus, those investors pay taxes on income which they may never receive. This is not disclosed to investors. At this time I do not know if the investors have any role in the decision whether to designate their investments as Qualified Funeral Trust, but it appears that the funeral directors, and not the investors, make that determination and apply it to all investors who purchase pre-need contracts from them.

26. After commencing participation in the Trust, investors receive no further communications from the Trust of any kind, except for those individuals who receive a Form 1099, which is the only other communication originating directly from the Trust to the investors. Upon request by an investor, the funeral home directors are able to provide the investor with the

current value of their “account,” which only permits the investor to see the reported value of their investment showing artificial gains with the “crediting rate” already applied.

27. I analyzed monthly account statements for the Trust’s investment portfolio produced for the Trust by the investment advisors, from September 2000 up to the present, which detail the specific securities in which the Trust is invested and the value of the portfolio at those points in time.

28. As early as September 2000, the Trust was invested in instruments such as mortgage-backed securities, foreign stocks purchased through American Depository Receipt, international bonds, corporate bonds, and cash not held by an FDIC insured institution. These investments were all prohibited by either the Trust’s Investment Policy or Wis. Stat. § 445.125(1)(b)(1).

29. By March 2002, The Trust’s portfolio was invested in preferred stocks, another prohibited investment.

30. In or about October 2002, the Trust Agreement was amended for the first time to allow more investment options. See Exhibit B.

31. In 2003, the Trust introduced Private Equity Investments in its portfolio. These types of securities are generally more speculative than stocks traded on an exchange and do not have a ready market value because they are not widely traded. Private equity securities are less liquid and riskier investments; they generally offer an opportunity for higher returns but expose investors to greater volatility and risk of losses.

32. Also in 2003, the Trust Pre-need Committee approved the recommendation of the investment advisors to use a complex investment strategy called “Municipal Arbitrage Trust” which entails building a portfolio of municipal bonds while simultaneously short selling interest

rate swaps as a hedge. This is a type of investment strategy employed by hedge fund managers and is not typical of an investment fund with more conservative goals and parameters as the Trust has been marketed.

33. In 2004, the Trust Agreement was amended a second time to name Fiduciary Partners, Inc. the trustee.

34. In 2004, the Trust began investing in hedge funds, another investment prohibited by the Trust's Investment Policy and the burial trust statute.

35. In 2006, the Trust began investing in Fixed Income Alternative Investments, which include instruments such as mortgage-backed securities and private placements, which were also prohibited.

36. In 2006, the investment advisors requested, and the Pre-need Committee approved, that they be permitted to invest and re-invest the Trust's funds with their own discretion and without the Committee's prior approval.

37. The Trust's investment portfolio today is an aggressive, high-risk selection of investments typical of a hedge fund. A hedge fund is typically characterized as an aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).

38. The Trust is largely indistinguishable from a hedge fund. The Trust's advisors use sophisticated investment strategies in an effort to produce an absolute return on investment, regardless of the state of the general market. Its portfolio is designed to achieve high growth at significant risk of loss. It is not a portfolio designed to ensure ready availability of the

investment funds, because a significant portion of the investments are illiquid and/or not readily marketable. Nor is the portfolio consistent with the Trust's conservative investment objective, which is to provide investors with the low and secure rate of return of 1% more than the state average three-year CD rate.

39. The Trust functions like a hedge fund in numerous ways, including:

- Investment Advisor has no real limits on investment vehicles/instruments permissible for portfolio;
- Investment Advisor has discretion over purchases and liquidations without approval;
- The investment portfolio frequently changes as the Trust's investment advisors are attempting to best the market and produce a targeted rate of return of 8.5%.
- The Trust actively moves in and out of certain investment options more than once or twice within a year and sometimes more than once a month;
- Investment Advisor has discretion over weightings of individual investments as well as overall asset class weightings;
- There is no true benchmark to compare performance and/or risk because the Investment Advisor has ability to change the underlying instruments and controls which market segments to invest into or move out of;
- Currently, the portfolio holds, Corporate Bonds, Bonds of Government Sponsored Entities, Options, Hedge Funds, Foreign Private Equities, Domestic Private Equities, Futures, Domestic ETF's, Foreign ETF's, Commodity ETF's, Individual International Equities, Individual Domestic Equities, Treasuries, Cash, and a wholly-owned life insurance subsidiary.

40. In 2009, the Trust formed Requia Life Insurance Co., to underwrite burial insurance sold through the Association's constituent funeral businesses. The Trust also owns 100% of the Requia stock. The burial insurance through Requia is offered to funeral clients as an alternative to investing in the Trust, but investors are never told that the Trust formed and owns Requia.

41. In 2007, the WFDA formed the Wisconsin Funeral Director Services, Inc., a for-profit corporation wholly owned by the WFDA, purportedly to provide services to the Trust. Although Requia is supposed to be wholly-owned by the Trust, it and the Trust each pay a separate royalty to the service company for the use of the WFDA's name, logo, and membership mailing list. Since the WFDA already owns the Trust, which in turn owns Requia, the WFDA is paying itself with investor funds for the use of its own name and trademarks. The WFDA also receives management fees from the Trust. The Association reported to the Division that the Trust paid out \$460,632 to the WFDA and the service company in the fiscal years ending March 2010 and March 2011. None of these fees are disclosed to investors.

42. According to the WFDA and trustee, investors are not given any information concerning: the Trust's investments; its value; any risks or potential losses from investing in the Trust; the payment of fees by the Trust to investment advisors, Third Party Administrators and other entities including the Association and a company wholly-owned by the Association; potential tax consequences and the need to seek out tax advice; the liquidity and/or solvency of the Trust's portfolio; any impediments to the ability of investors to revoke their pre-need contract and recover their invested funds; the authority and powers of the Association to control, modify, and/or affect the operations of the Trust, including the ability to terminate the Trust at will; the scopes and limits of any duties owed to investors by the trustee and/or the Association; changes

to the Trust's investment advisors; that the Trust is operated contrary to Wis. Stat. § 445.125(1)(b)1; that the Trust's liabilities significantly exceed the value of the assets; or that amounts invested by one individual may be used to fund the funeral services for other individuals.

43. According to information provided by the WFDA, the Trust currently has 10,755 investors who have contributed a net of \$54,200,608.24 to the Trust, for an average of \$5,040 per investor. Given the current value of the Trust at \$48,347,481.09, the Trust has already lost \$5,853,127.15 in investor funds representing nearly 11% of all of the funds contributed by current investors in the Trust.

44. The Trust's portfolio has sustained significant losses to date and recently infused an additional \$1 million into Requia to cover its legal capital requirements. As of July 31, 2012, the current value of the Trust's portfolio and other assets is \$48,347,481.09. However, the Trust has guaranteed a rate of return to the investors through its crediting rate. As of July 31, 2012, it owes investors a total \$69,879,947.041. Thus, the Trust has a deficit of more than \$21,500,000, with assets only sufficient to cover 69% of the Trust's liabilities.

45. According to the Preeed Funeral Contract, an individual can only designate up to \$3,000.00 of their contribution as irrevocable plus any income earned on their contribution to the Trust. However, the Trust to date has sustained net losses, so no irrevocable income has been generated and only \$3,000 per investor is irrevocable. Thus, even under the most conservative assumption that every Trust investor elected the irrevocable designation, each investor in the Trust has the ability to cash out of the Trust an average of \$2,040, with a total of at least \$21,940,200 revocable at will from the Trust. This represents more than 45% of the Trust's total assets today.

46. Despite sustaining losses, the Trust has been paying out at the credited rate, so investors to date have received the guaranteed rate of return when they die or revoke the contract. By continuing to pay benefits at the putative “guaranteed” rate while the Trust assets in actuality have declined in value, the Trust is operating in some ways like a Ponzi scheme whereby the Trust corpus is depleted to pay out current obligations at an artificial rate, endangering the ability of new investors to ever recover their original investment, let alone the returns they have been promised.

47. These circumstances raise the question of whether the Trust has the resources available to satisfy a run if panicked investors decide to revoke their contracts. A significant portion of the Trust’s portfolio is invested in illiquid instruments with no ready market and no truly verifiable value. The Trust does not appear to hold sufficient liquid assets to satisfy the total revocation liabilities that are callable at will by the investors.

48. The Trust has not been registered as a security with the Division. Also, the funeral directors selling participation in the Trust have not been registered with the Division as sales agents.

49. Attached hereto as Exhibit J is a true and correct copy of an email I received on September 12, 2012, from legal counsel for Fiduciary Partners, Inc., responding to several questions posed by DFI in the course of investigating this matter.

Scott O. Conwell

SCOTT O. CONWELL

Subscribed and sworn to before me

this 13th day of September, 2012.

[Signature]

Notary Public, State of Wisconsin
My Commission is permanent.