



The Commonwealth of Massachusetts
Office of the Inspector General

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Joseph E. Connarton, Executive Director
Public Employee Retirement Administration Commission
5 Middlesex Avenue, 3rd floor
Somerville, MA 02145

Dear Mr. Connarton,

It has come to my attention that the Public Employee Retirement Administration Commission is on the verge of approving its Final Investigative Report on the Middlesex Retirement System and Cambridge Financial Management.

I also understand that the commissioners plan to vote later this month on whether to lift PERAC's temporary order restricting the Middlesex Retirement System's investment activities. PERAC imposed the temporary order in 2003 in response to the \$37 million loss Middlesex suffered at the hands of Cambridge Financial Management, one of its financial managers.

I appreciate the assistance and cooperation of PERAC and its entire staff during the Inspector General's investigation of this matter. I am writing this letter to update you on my office's investigation and to urge you to keep the temporary order in place until the Middlesex Retirement System fully answers all questions about Cambridge Financial Management's investment activity and the questionable fee arrangement that siphoned \$2.8 million from public employee pension funds for the benefit of two men, Ronald A. Whitham and Thomas F. Kelly, who had little or no role in the company's investments.

As you know, the loss accrued over a three year period, starting in the spring of 2000, and went undetected until Cambridge Financial Management's principal James Kneafsey died suddenly on April 21, 2003. The Middlesex Retirement System, PERAC and Wainwright Investment Counsel were all receiving monthly trading reports that contained numerous clues that Kneafsey entered a trading frenzy as he attempted to recoup his losses. The reports, as your own investigation has found, were doctored to hide the extent of the losses but they clearly showed that Kneafsey's trades violated

both his contract with the Middlesex Retirement System and PERAC regulations.

These huge losses, amounting to about 7 percent of the fund's assets, came at a time when Cambridge Financial Management's president was ostensibly providing "currency overlay" – that is, investing in foreign currency futures to protect Middlesex Retirement System's international investments from losing value when the U.S. dollar rose. Instead, within months of being hired by Middlesex Retirement System as an investment manager, Kneafsey began engaging in the highly speculative and risky practice of writing options on foreign currencies.

As your staff has thoroughly documented, Kneafsey's actions were both wildly at odds with a currency overlay program and detectable. Unfortunately for contributors to and beneficiaries of the Middlesex Retirement System, officials of the Middlesex Retirement System, Wainwright Investment Counsel and PERAC failed to detect Kneafsey's errant trading until after his death.

The clearest contemporaneous indication that Kneafsey had strayed dramatically from his contract with Middlesex Retirement System was the steady, pronounced escalation in trading. Kneafsey started running a conventional currency overlay program in September 1999 for the Middlesex Retirement System. Beginning in early 2000, Kneafsey started writing currency options, essentially betting on the future value of foreign currencies. Once Kneafsey began trading with Goldman Sachs in November 2000, the pace of trading escalated significantly. Kneafsey's actions had veered from providing the Middlesex Retirement System with a form of insurance against swings in the value of foreign currencies into investing directly in the high-risk and highly leveraged foreign exchange markets.

Perhaps in excess of two-thirds of the Middlesex Retirement System's \$37 million loss is attributable to transaction costs associated with the frenzied trading by Cambridge Financial Management. Kneafsey was originally given \$4 million by the Middlesex Retirement System board to set up and run the currency overlay program. The losses and transaction costs exceeded this amount many times over but due to poor oversight, Kneafsey was able to continue the speculative trading in the Middlesex Retirement System's account. Because the Middlesex Retirement System account received a premium each time Kneafsey wrote a futures option, the more trades he initiated, the more premiums came in. These premiums – and the failure to recognize the significance of the reports showing Kneafsey's frenetic trading – helped disguise the mounting losses and provided the cash flow to allow Kneafsey to continue trading.

Kneafsey was also trading for another institutional investor, the Massachusetts Bay Transportation Authority Retirement Fund. When Kneafsey died, MBTA Retirement Fund officials discovered their fund also had lost a large amount of money, more than the Middlesex Retirement System, as a result of Kneafsey's speculation. While many of the causes and people responsible for the losses borne by the Middlesex Retirement System and the MBTA Retirement Fund are identical, the MBTA Retirement Fund is not a governmental entity. As a result, the Inspector General did not review that fund's

dealings with Cambridge Financial Management.

The Inspector General's review has focused on two local companies that received what appear to be inordinately large benefits as a result of Kneafsey's improper trading. In fact, each of the companies performed little or no work related to the Middlesex Retirement System account yet they received much more money as a result of the trades than Kneafsey himself did as an investment manager.

More than \$1.9 million of Middlesex Retirement System funds went to a one-person firm operated by a South Shore man, Ronald A. Whitham, from his Weymouth home. This man's firm, RAW Inc., received another \$935,860 as a result of Kneafsey's trades on behalf of the MBTA Retirement Fund.

The \$2.8 million that Goldman Sachs paid RAW Inc. between November 2000 and April 2003 represent commissions on trades made by Kneafsey with Goldman Sachs. Whitham and Goldman Sachs signed a contract in February 2000 under which Whitham's firm, as the so-called "introducing broker," would receive \$50 for every \$1 million in options traded through Goldman Sachs. This "introducing broker" arrangement is rare, according to contemporaneous internal Goldman Sachs e-mails. The firm agreed to it because all the costs were charged to the Middlesex Retirement System and MBTA Retirement Fund accounts managed by Cambridge Financial Management and therefore did not affect Goldman Sachs's profits. Goldman Sachs built RAW Inc.'s fees into the price of the options rather than itemizing the cost separately. While Goldman Sachs wrote the check to RAW Inc., the entire commission cost was levied against the two pension funds.

In an interview earlier this year with members of the Inspector General's staff, Whitham acknowledged that he set up RAW Inc. in July 1999 to receive commissions on currency futures trades and that Kneafsey was his only customer conducting these trades. More than 95 percent of the deposits into RAW Inc.'s bank account were from Goldman Sachs for commissions on Kneafsey's trades.

During the period he received \$2.8 million from Goldman Sachs into his RAW Inc. account, Whitham paid out almost exactly half that amount – \$1.4 million – to another local firm, CanAm Consultants Inc. The first \$10,000 payment was made shortly before Whitham started collecting fees from Goldman Sachs. The payments stopped when Kneafsey died.

Based in Boston, CanAm Consultants provides so-called "third-party marketing" services for businesses, including investment companies and venture capital firms seeking to raise capital from pension funds. Thomas F. Kelly is the principal officer of CanAm Consultants, founded in 1988.

PERAC regulations require investment managers to disclose any third-party marketing arrangements or commission agreements. Cambridge Financial Management's disclosure form states it did not have any such contracts.

Interviews with and documents from Goldman Sachs underline the highly unusual nature of the arrangements between Cambridge Financial Management and RAW Inc. First, the fees paid to RAW Inc. are uncharacteristically large. An internal email in 2002 from a Goldman Sachs vice-president to the sales representative handling Cambridge Financial Management described the commission rate as “pretty high” for options brokerage. The sales representative responded, “yes, I know it is ridiculous but then again it doesn’t effect [sic] us.”

In an interview, the sales representative said that during the several years he worked at Goldman Sachs, he knew of only one other account which generated fees for an “introducing broker.” Such arrangements are very rare, he said.

The circumstances that led to Whitham’s becoming the introducing broker were even more peculiar. According to Goldman Sachs, Whitham did not do any “introducing” at all. The Goldman Sachs sales representative, Dan Silber, saw Kneafsey’s name in a business directory and cold-called him. “I was looking through Nelson’s directory of money managers,” Silber said in an interview. Silber said, “I called Jim directly.”

Once Silber made contact, Kneafsey expressed interest in trading with Goldman Sachs but he imposed one condition: Goldman Sachs must establish an “introducing broker” relationship with Whitham as a pre-condition of doing business. This pre-requisite was referenced in contemporaneous internal emails as well as interviews after Kneafsey’s death with Goldman Sachs personnel. In a Sept. 28, 1999 email, the institutional sales representative wrote to a colleague, “a prospect I am entertaining (Cambridge Financial Mgmt.) said it can only deal with us if we ‘pay’ their introducing broker a fee for every trade we do...the client not only knows about the arrangement (disclosure) but cannot deal with us unless we have this arrangement.” (Parentheses in original.) As a result, in February 2000, Goldman Sachs signed a finder’s fee agreement with Whitham, adding \$50 onto Cambridge Financial Management’s costs for every \$1 million in options transacted and passing that amount on to Whitham.

Whitham, in an interview, contradicted the Goldman Sachs account of how Kneafsey began doing business with Goldman Sachs. Whitham claimed that he initiated contact with Goldman Sachs and a number of other foreign exchange firms in late 1999 when Kneafsey got interested in trading unlisted options. “I literally knocked on doors in banks across the country,” Whitham told the Inspector General. “I interviewed a number of banks.”

This claim is unconvincing. Whitham offered no evidence that he had ever contacted any other trading firm on Kneafsey’s behalf. He could not name any individual at any firm he spoke to and he had difficulty even coming up with the names of trading firms he claimed to have contacted.

Regarding the size of his fee, Whitham said he had no idea if the \$50 per \$1 million rate was higher than, lower than, or in line with industry practices. This claim is somewhat

plausible given that Whitham had virtually no experience with this type of trading and no other customers. By his own account, Whitham spent most of the 1990s away from the securities business, working as a basketball coach and trying to build up a basketball clinic business. However, Whitham was not completely naïve about these matters. He had previously signed “introducing broker” deals with two other firms – Saul Stone & Co. and Fleet Bank – covering Kneafsey’s trades.

The arrangements for the Saul Stone trades mirror those of the Goldman Sachs trades in certain ways. Saul Stone paid the introducing broker fees to a company called Alaric Corporation, a one-person firm Whitham set up in 1996. As he did later with RAW Inc., Whitham wrote checks from Alaric’s account to Kelly.

In the interview, Whitham was questioned about his payments to Kelly’s firm. Whitham denied that Kelly was being paid as part of an arrangement to share the fees generated by Kneafsey’s frenetic trading with Goldman Sachs on the Middlesex Retirement System and MBTA Retirement Fund accounts. Whitham claimed that he paid Kelly to get certain investment firms to steer their stock brokerage trades through another company, Source Capital, where Whitham had his securities license and would receive commissions on the stock trades. Whitham said the payments were outlined in finder’s fee agreements between Whitham and Kelly. Each finder’s fee agreement called for Whitham to pay Kelly a flat fee of between \$50,000 and \$150,000, but he often paid Kelly more than the contract required, Whitham said.

“I overpaid him basically in an attempt to entice him to bring me more (business),” Whitham said in his interview. “I was anticipating and hoping that the more money I could get to CanAm, the more he’d be willing to help me.”

Whitham estimated he paid Kelly \$500,000. (The actual figure is \$1.4 million over a period of about 32 months.) He said Kelly generated very little brokerage business for him – far less than he paid Kelly. Nevertheless, he kept paying Kelly steadily and handsomely right through April 2003 and Kneafsey’s death.

“I know it looks like I’m paying him for the Cambridge situation (but) I was paying him for what he could do in the future,” Whitham told the Inspector General.

Whitham said he is not friends with Kelly. He said they first met when Whitham worked at a tiny Boston brokerage firm called the William G. Manning Co. in the late 1980s and early 1990s. Whitham said they had been out of touch for years until Whitham got back in the business through Kneafsey. Even during the 2000 to 2003 period when he was paying Kelly huge fees purportedly to drum up stock brokerage business, Whitham said he rarely talked to Kelly – once a month at the most. Mobile phone records show that Whitham telephoned Kelly about once a month, including a call to his home the day Kneafsey died.

Whitham’s contention that his \$1.4 million in payments to Kelly is unrelated to Cambridge Financial Management is implausible. RAW Inc.’s checks to Kelly began just

before Kneafsey started trading with Goldman Sachs, they stopped when Whitham's fees from Goldman Sachs stopped, and the amount totalled almost exactly half the fees paid by Goldman Sachs. Whitham acknowledged that the amounts on the checks he wrote to Kelly bore no relation to the volume of brokerage business Kelly generated for him. By contrast, the amounts roughly tracked the Goldman Sachs fees – going up as Whitham's fee income went up.

When the Middlesex Retirement System board voted to hire Cambridge Financial Management in 1998, Richard Zaccaro was a top official at Wainwright Investment Counsel LLC, the investment consultant for the Middlesex Retirement System and the outside entity that was under contract to vet investment managers, ensure compliance with their contracts and guidelines, and monitor investment performance. Middlesex Retirement System meeting minutes show that Zaccaro was personally involved in the process that resulted in the Middlesex Retirement System board hiring Cambridge Financial Management.

In response to questions from the Inspector General, Whitham described his relationship to Zaccaro. He said he first met Zaccaro in the 1980s and 1990s, the period when Whitham was working at the William G. Manning Co. and the same period when he met Kelly. Whitham said he occasionally met Zaccaro at a fundraiser. He said Zaccaro's son also attended one of Whitham's basketball programs, which Whitham was operating in the mid- to late-1990s.

Kelly, Kneafsey, Zaccaro, and William G. Manning, whose company Whitham worked for, all have something in common – past ties to the state treasurer's office during the tenure of Robert Q. Crane. Kelly and Zaccaro were top aides to Treasurer Crane. Treasurer Crane chose Kneafsey to manage some state pension money. At the end of his last term, Treasurer Crane directed state pension investments to several firms represented by Manning, a long-time friend from Brighton, or Manning's son.

Kelly also had a relationship with Kneafsey during the period when Cambridge Financial Management was trading with Goldman Sachs. In a July 18, 2001 letter provided by Wainwright Investment Counsel in response to a subpoena, Kelly wrote, "I am sorry you were unable to join us for the Foreign Currency Overlay Seminar at Jimmy's on June 27th." The seminar featured Kneafsey discussing the benefits of currency overlay and the letter summarizes why pension funds might need this type of investment. The document, which appears to be a form letter, ends by telling the recipient to call Kelly with any questions about Cambridge Financial Management.

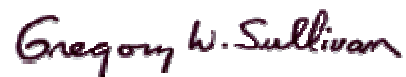
Middlesex Retirement System officials were apparently aware that Kelly may have had involvement in the investment that cost the system's beneficiaries \$37 million. In a June 18, 2003 facsimile provided in response to a subpoena, a public relations consultant working for the fund sent a copy of a Globe column on the Cambridge Financial Management scandal to Middlesex Retirement System's then-chairman. On the cover page, the public relations consultant wrote, "It is good that there is no mention of Tom Kelly."

To this point, Middlesex Retirement System officials have not been asked formally about their dealings with Kelly, if any. In late 2003, PERAC asked Middlesex Retirement System officials about RAW Inc. and Whitham. Middlesex Retirement System's response was that no one had any contact with or about RAW Inc. Regarding Whitham, the response was, "Not enough information is given with regard to the question above to identify this individual." However, in a chronology Middlesex Retirement System officials prepared for PERAC, they identify Whitham as "a friend of Kneafsey's."

PERAC's draft of the final report makes clear that it is unsatisfied with Whitham's explanation of his arrangement with Cambridge Financial Management. The account he gave the Inspector General about why he paid Kelly \$1.4 million strains believability. Middlesex Retirement System officials have not been forthcoming about what they knew about Kelly and Whitham's activities nor have they addressed their own failures to properly oversee Cambridge Financial Management. Middlesex Retirement System officials have excused and overlooked the deficient performance of their investment consultant, Wainwright Investment Counsel. In addition, to date no one has questioned Kelly about why he received so much money from Whitham.

I strongly recommend that PERAC keep the temporary order in place until Middlesex Retirement System officials thoroughly explain Whitham's and Kelly's roles in this scandal. If the Middlesex Retirement System is unable – or unwilling – to explain why these two men made money while the contributors to and beneficiaries of the pension fund lost tens of millions of dollars, PERAC should use all its authority to force the Middlesex Retirement System to move its assets to the Pension Reserves Investment Trust.

Sincerely,

A handwritten signature in dark ink that reads "Gregory W. Sullivan". The signature is written in a cursive, slightly slanted style.

Gregory W. Sullivan
Inspector General