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INDEPENDENT STATE AUDITOR'S REPORT
ON CERTAIN ACTIVITIES OF THE
PENSION RESERVES INVESTMENT
MANAGEMENT BOARD

OFFICIAL AUDIT
REPORT

JULY 15, 2002

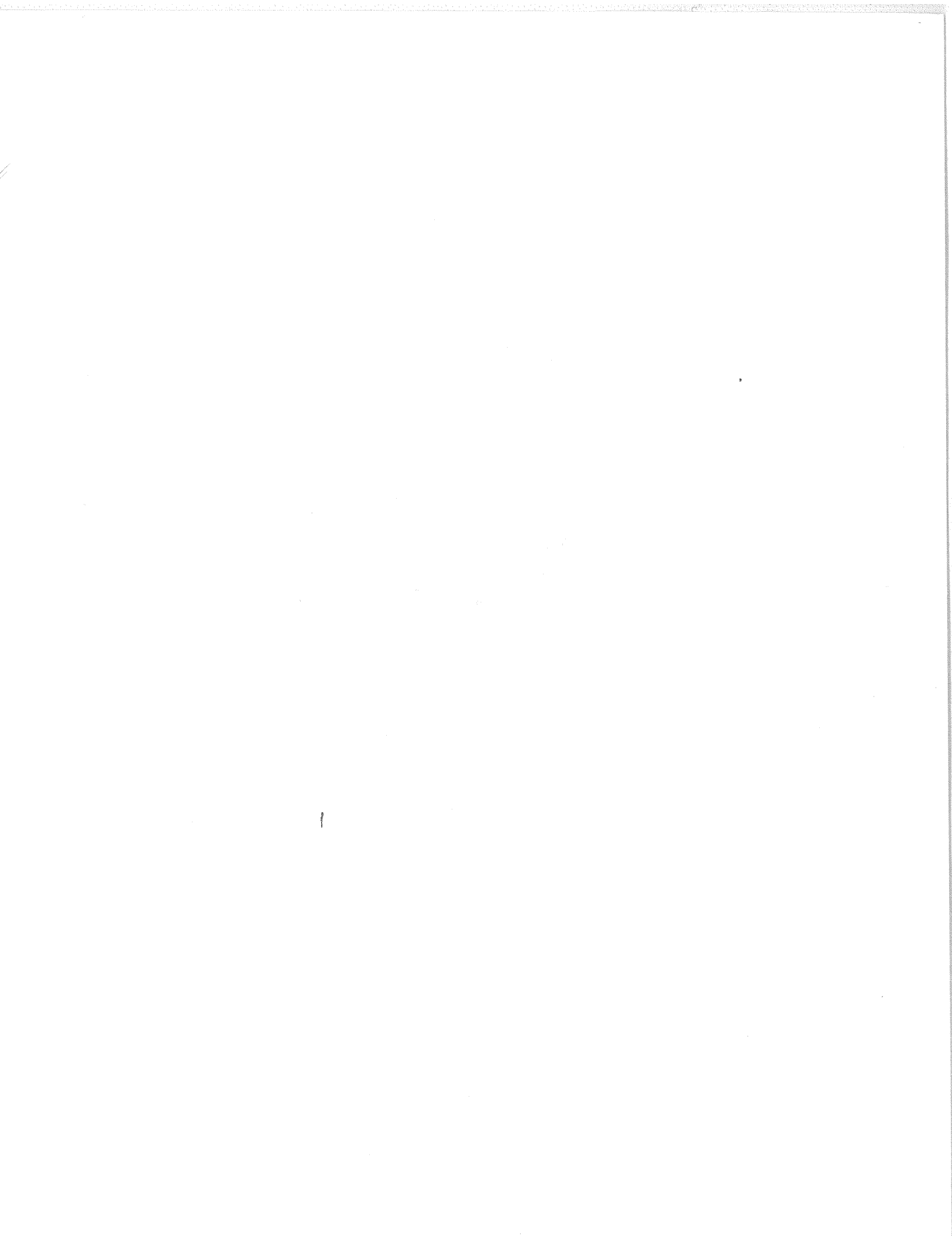


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INTRODUCTION

Background

Chapter 661 of the Acts of 1983 established the Pension Reserves Investment Management Board (PRIM). The mission of PRIM is to maximize the return on investment of the State Teachers' Retirement System, the State Employees' Retirement System, and any other Massachusetts public pension fund that elects to participate, within acceptable levels of risk by broadly diversifying its investment portfolio, capitalizing on economies of scale to achieve cost-effective operations, and providing access to high-quality, innovative investment firms, all under the management of a professional staff and members of the PRIM Board. The PRIM Board's nine members are the State Treasurer, ex officio, or her designee, who serves as Chair of the board; the Governor, ex officio, or her designee; a private citizen experienced in the field of investment or financial management appointed by the State Treasurer; an employee or retiree who is a member of the State Teachers' Retirement System elected by the members of such system; an employee or retiree who is a member of the State Retirement System elected by the members of such system; an employee or retiree who is a member of the State Retirement Board; one of the elected members of the Teachers' Retirement Board, chosen by the members of the Teachers' Retirement Board; a person who is not an employee or official of the Commonwealth appointed by the Governor; and a representative of a public safety union who is appointed by the Governor.

The members of the PRIM Board, as trustees for each retirement system that invests in the Pension Reserves Investment Trust (PRIT) Fund, have authority to employ an Executive Director, outside investment managers, custodians, consultants, and others to formulate policies and procedures and to take such other actions as deemed necessary and appropriate to manage the assets of the PRIT Fund. The Executive Director, with the assistance of staff, has responsibility to assist the PRIM Board and its committee in establishing investment and administrative policy; to implement the policies and programs established by the PRIM Board; and to report to the PRIM Board on the status of the PRIT Fund and the operations of PRIM. The PRIM Board has established four standing committees, consisting of an administrative

committee, an audit committee, an investment committee, and a real estate committee, to assist the board in carrying out its duties.

Chapter 661 of the Acts of 1983, as amended by Chapter 315 of the Acts of 1996, created the PRIT Fund under the management of PRIM. The PRIT Fund is a pooled investment fund established to invest the assets of the Massachusetts State Teachers' and State Employees' Retirement systems and the assets of county, authority, district, and municipal retirement systems that elect to invest in the fund. The mission of PRIT is to ensure that current and future benefit obligations are adequately funded in a cost-effective manner and to maximize the total return on investment within acceptable levels of risk. Under current law, by 2018 the PRIT Fund, through annual payments in accordance with a legislatively approved funding schedule and through accumulated investment returns of the fund, should be fully funded to meet the then-existing pension obligations of the Commonwealth. The Commonwealth has adopted a schedule of state pension appropriations that assumes a long-term actuarial rate of return of 8.25%.

Retirement systems electing to invest in the PRIT Fund have the option of being either a Participating System or a Purchasing System. Participating Systems are required by statute to place all of their retirement funds in PRIT and commit to remain invested for five years, whereas Purchasing Systems may allocate a certain amount of their funds to PRIT, with the option to contribute and withdraw funds at their discretion.

Purchasing and Participating systems both share in the investment earnings of the PRIT Fund based on their proportionate share of net assets invested. There are currently 19 Participating Systems and 23 Purchasing Systems with investments in the PRIT Fund. (See Appendices I and II.)

Chapter 84 of the Acts of 1996 authorized Massachusetts authority, county, city, and town retirement boards to purchase units in the separate investment accounts of PRIT as an alternative to investing in the General Allocation Account. This investment option, also referred to as "segmentation," was established by an amendment to PRIT's Operating Trust in 1994 in

response to requests from Massachusetts retirement boards wishing to invest in separate asset classes of PRIT.

As of December 31, 2001, the net assets of the PRIT Fund totaled \$28,793,018,148 with net assets declining in value by \$2,740,151,809, for the 18 month period ending December 31, 2001 (see Appendix III). PRIM operational costs were \$116,308,645 for the latest fiscal year ended June 30, 2001. (See Appendix V). Investment performance results declined over the two years ended December 31, 2001, with the fund experiencing declines of -5.32% and -1.2% as of December 31, 2001 and December 31, 2000 respectively. However, the fund's five-year performance of 9.41% has outpaced the 8.25% rate of return assumption required by the state pension funding schedule. (See Appendix IV.)

In comparison to the other Massachusetts public pension systems, PRIM's investment performance ranked 86th of 107 systems that reported in 2001 and ranked 45th of 107 systems over the last five years.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the Office of the State Auditor conducted an audit of the PRIM Board in accordance with applicable generally accepted government auditing standards. Our audit period covered the period July 1, 2000 to December 31, 2001.

The purpose of our audit was to determine whether the PRIM Board has efficiently and effectively implemented internal controls over financial activities and records, and contract bidding and monitoring policies and practices, particularly as they relate to contract costs. Additionally, we determined whether PRIM has adequate controls in place to safeguard assets and has been complying with applicable laws, rules, and regulations.

To accomplish our audit, we first assessed the management controls established and implemented by PRIM over its operations. We reviewed organizational charts; annual reports; internal policies and procedures; and applicable laws, rules, and regulations. We also examined pertinent documentation to determine whether operational and contracted expenses incurred

were reasonable, allowable, properly authorized and recorded, and in compliance with the scope and mission of PRIM's enabling legislation and regulations. Specifically, we:

- Interviewed PRIM staff to gain an overall understanding of the entire financial and operational environment at PRIM.
- Analyzed and tested management fees paid by PRIM to its contracted investment managers and consultants to ensure proper review, approval, and compliance with contractual terms.
- Reviewed PRIM's contract bidding, evaluation, and awarding processes to ensure their adequacy and compliance with the Commonwealth's procurement regulations.
- Reviewed PRIM's controls over the monitoring of its contracted investment managers.
- Reviewed PRIM's asset allocation plan.
- Reviewed the most recent private accounting firm's audit reports on PRIM.

While our audit was in progress, and at the conclusion of our audit field work, we discussed our conclusions with PRIM officials, whose responses have been considered and incorporated into our report, where appropriate.

AUDIT RESULTS

1. UNAUTHORIZED SALARY INCREASE FOR PRIM'S EXECUTIVE DIRECTOR

Our review disclosed that the Executive Director of the Pension Reserves Investment Management Board (PRIM), who was hired on April 2, 2001 at a salary of \$149,350, received a \$50,650 salary increase to \$200,000 three months later that was not authorized by the PRIM Board. We reviewed the minutes of PRIM Board meetings to determine whether the salary increase was addressed and approved by the board. The minutes, however, did not indicate that the PRIM Board was cognizant of or had approved the salary increase. According to the Executive Director and the Chief Financial Officer of PRIM, the following sequence of events that led to the salary increase to the Executive Director:

- A search committee was set up with the authority to conduct a search and make a recommendation for the replacement of the prior Executive Director.
- The search committee's recommendations were presented to the Chairperson, who was responsible for the final negotiations and hiring of the Executive Director.
- The board approved the hiring on March 27, 2001.
- Because a Chief Investment Officer was being recruited at the same time and that salary was increased to \$200,000 to attract qualified candidates, board members felt that the salary of the Chief Investment Officer should not be greater than the salary of the Executive Director, and discussions commenced on raising the salary of the new Executive Director from \$149,350 to \$200,000.

In response to our written inquiry on why the minutes of PRIM's board meetings did not address the increase to the Executive Director's salary, we were provided a written memorandum by the Chief Financial Officer that stated, in part:

Mr. Hearty's salary increase on July 1, 2001 was the result of a new hire negotiation....The Search Committee was charged with the responsibility of salary negotiations with the new Executive Director upon final approval of the Board Chairperson. In this situation, the Search Committee, with the Chair's approval, agreed to an annual compensation of \$200,000 for the Executive Director. As the fiscal year 2001 budget had previously been approved with the Executive Director's salary at \$149,350, the Search Committee negotiated with Mr. Hearty to commence employment with PRIM at the outgoing Executive Director's salary of \$149,350 until June 30, 2001, with the agreement that his salary would be increased to \$200,000 for fiscal year 2002. During the March 27, 2001 board meeting, the PRIM Board,

based upon the recommendation of the Search Committee, approved the hiring of Mr. Hearty and approved in a separate vote the proposed operating budget for the fiscal year 2002, which included a salary budget of \$1,882,000.

Notwithstanding this response, there was no evidence provided of any board action regarding the Executive Director's salary or his salary increase to \$200,000. Also, when we inquired whether there was an employment contract stipulating the Executive Director's salary and the process for increasing the Executive Director's salary, we were informed that there was none.

Chapter 32, Section 23, of the Massachusetts General Laws states that the "PRIM board shall select an executive director who shall serve at the pleasure of the board." Although the law does not address specific procedures for establishing the salary of the Executive Director, it is clearly the responsibility of the PRIM Board to set and formally approve this amount.

Recommendation: The PRIM Board should:

- Conduct a review to determine whether the salary of the current Executive Director is appropriate, and if so, formally approve the compensation level.
- Establish a formal policy and process whereby the board complies with its responsibility in actively approving the salary and all salary adjustments of the Executive Director.

2. THE PRIM BOARD DID NOT COMPLY WITH THE OPEN MEETING LAW REGARDING PRIM'S ADVISORY COMMITTEE MEETINGS OR PROVIDE NOTIFICATION TO ITS MEMBER PARTICIPATING AND PURCHASING SYSTEM PARTICIPANTS OF ITS ADVISORY INVESTMENT COMMITTEE MEETINGS

a. The PRIM Board Did Not Comply With Open Meeting Law Regarding PRIM's Advisory Committee Meetings

The PRIM Board did not adhere to certain provisions of Chapter 30A, Section 11A 1/2, of the General Laws, known as the "Open Meetings of Governmental Bodies," during our audit period. Specifically, we noted that notices were not forwarded to the Office of the Secretary of State and the Executive Office for Administration and Finance of its advisory committee meetings: Chapter 30A, Section 11A1/2, states, in part:

Except in an emergency, a notice of every meeting of a governmental body subject to this section shall be filed with the secretary of state, and a copy thereof posted in the office of the executive office for administration and finance at least forty-eight hours, including Saturdays but not Sundays and legal holidays, prior to the time of such meeting.

In response to our inquiry on whether committee meetings are considered public meetings, PRIM's Chief Financial Officer stated:

Prior to March 2002 committee meetings, PRIM did not consider the advisory committee meetings to be public meetings and therefore, did not post the meetings. The PRIM Board is currently reviewing with legal counsel as to whether advisory committee meetings are deemed public meetings. The Board has begun posting all advisory meetings, as of March 2002 meeting and will continue to do so unless legal counsel advises the Board otherwise.

b. The PRIM Board Did Not Provide Notification to its Member Participating and Purchasing System Participants of its Investment Advisory Committee Meetings

PRIM's investment committee is charged with the responsibility of reviewing all investment-related policy performance and management issues. In addition, the committee reviews and recommends to the board the broad asset allocation among various asset classes and reviews and recommends investment structure. As of December 31, 2001, there were 19 member Participating Systems and 23 member Purchasing Systems that were invested in the PRIT Fund. (See Appendices No. I and II.) Because the PRIM investment committee is a key decision maker in the investment of the PRIT Fund, and the Purchasing and Participating systems have a vested interest in the fund, it clearly would be beneficial for member systems to be afforded the opportunity to attend these meetings.

In response to our written inquiry about PRIM's policy on notifying the Participating and Purchasing systems of PRIM's investment committee meetings, PRIM's Chief Financial Officer stated:

Participating and Purchasing Systems participants are not specifically notified of the investment committee meetings, however, they are aware of PRIM's investment policy and process and are welcome to attend any and all meetings.

Recommendation: PRIM should:

- Provide notices to the Secretary of State and Executive Office for Administration and Finance of all its advisory committee meetings.
- Provide written notification to its member Participating and Purchasing systems of PRIM's investment meetings to afford them the opportunity to attend meetings that deliberate on the investment of their pension system's funds.

3. THE PRIM BOARD HAS NOT PURSUED THE RECOVERY OF \$22,705,685 IN REALIZED LOSSES ON ENRON STOCK TO THE EXTENT IT SHOULD

During the period of our review, Enron Corporation suffered significant financial losses and declared bankruptcy amid allegations of financial mismanagement and accounting irregularities. Accordingly, we attempted to verify Enron stock losses sustained by the PRIT Fund and determine whether any actions were being taken by PRIM to recover these losses.

On December 7, 2001, on behalf of PRIM, the Office of the State Treasurer released an accounting disclosure of all Enron stock transactions made by investment firms for PRIM from 1998 to 2001. Our review determined that this initial disclosure did not provide complete information on all Enron stock transactions for that period. Based on additional information subsequently provided by PRIM staff, realized losses on Enron transactions were actually \$5,822,377 more than originally reported. Our review also disclosed that the PRIM Board has not actively pursued the recovery of losses incurred from the purchase and sale of Enron stock by its contracted investment managers, as discussed below:

a. Initial Disclosure of Enron Stock Transactions of PRIM's Contracted Investment Managers

On December 7, 2001, the Office of the State Treasurer announced that PRIM had completed an accounting of all 11,000 equity positions it held to identify the holdings of Enron stock for the period 1998 to 2001 that were held by contracted investment managers on behalf of the PRIM Board. The accounting stated that 1,762,200 shares of Enron were purchased in 2001 and that 12,000 shares were purchased in December 2000. This accounting showed a detailed analysis of the purchases and sales of Enron stock by PRIM's contracted investment managers from 1998 to 2001, as follows:

- Fidelity purchased 12,000 shares of Enron in December 2000 and 23,100 shares in July 2001 for an aggregate cost of \$1,970,420. Fidelity sold the 35,100 shares during the period March to August 2001 for \$1,849,079, resulting in a net loss of \$121,341.
- J.P. Morgan purchased 44,100 shares of Enron during the period March 2001 to November 2001 for an aggregate cost of \$1,096,495. J.P. Morgan sold the 44,100 shares during the period August to November 2001 for \$93,874, resulting in a net loss of \$1,002,621.
- Legg Mason purchased 1.695 million shares of Enron during the months of October and November 2001 at a cost of \$16,470,605. Legg Mason sold the 1.695 million shares on November 28 and 29, 2001 for \$711,259, resulting in a net loss of \$15,759,346.

In summary, this disclosure indicated that PRIM lost \$16,883,308 from the purchase and sale of Enron stock by its contracted investment managers from 1998 to 2001.

During our review, we requested all Enron stock transactions for the period 1998 through 2001. After reviewing additional information provided by PRIM staff, we determined that the State Treasurer's December 7, 2001 accounting understated the extent of the loss incurred by PRIM because it neglected to disclose all the purchases and sales of Enron stock by all of PRIM's contracted investment managers. Specifically, PRIM provided us with an accounting of the Enron shares purchased and sold by State Street Global Advisors (SSGA) as part of its Standard & Poor's index fund, that was not included in the December 7, 2001 disclosure. We noted that the following Enron transaction history for the period January 1, 1998 through December 31, 2001 was omitted from its accounting:

- On January 1, 1998 SSGA held 275,200 shares of Enron stock at a cost of \$10,078,798.
- From January 1, 1998 to December 31, 2001 SSGA purchased 81,379 shares of Enron stock for PRIT.
- On August 1, 1999 PRIT received 275,500 shares of Enron stock as a result of a 2-1 stock split.
- From January 1, 1998 to November 28, 2001 SSGA sold 147,135 shares of Enron stock for PRIT resulting in realized gains of \$5,224,083.
- On November 29, 2001 SSGA sold the remaining 484,944 shares of Enron stock for PRIT at a loss of \$11,046,460.

- The total loss to PRIT resulting from SSGA transactions in Enron stock from January 1, 1998 to December 31, 2001 amounted to \$5,822,377.

When we inquired why SSGA's Enron transactions were not initially disclosed, PRIM's Chief Financial Officer stated, in part:

In a press release dated December 7, 2001 the Treasurer's Office was responding to specific requests from various media outlets for a complete accounting of all Enron transactions in PRIM's actively managed stock portfolios. While these media outlets were aware of additional shares held by PRIM in the S&P 500 fund managed by SSGA, they did not seek information regarding these transactions.

b. Lack of Sufficient Action Taken by PRIM Board to Recover Money Incurred from the Purchase and Sale of Its Investments in Enron Stock

Our review of the detailed buy and sell activities of PRIM's outside investment managers revealed questionable actions given the serious financial difficulties experienced by Enron, which was evident in information available to the investment community by September 2001. We noted, for example, that Legg Mason purchased 1.695 million shares of Enron during October and November 2001 when prices were declining and ultimately lost \$15,759,346. Also, SSGA, which had bought and sold Enron shares as part of an index fund, over an extended period held 484,984 shares of Enron stock for PRIT until November 29, 2001, at which time it sold all 484,984 shares at \$.37 per share, for a loss on that day alone of \$11,046,460.

Several state pension programs, including those of California, New York, Ohio, and Washington, are involved in lawsuits against Enron. In addition, other states have decided to join a class action suit in attempting to recoup its losses incurred from the purchase of Enron stock. PRIM officials indicated that they are participating in the class action suit filed against Enron. Also, the Florida Pension Board has authorized its fund directors to seek reimbursement by filing suit against its contracted investment manager on the grounds that its investment manager failed to conduct rigorous company specific research as required by its Investment Management Agreement.

We reviewed the minutes of meetings of the PRIM Board to determine whether any attempt has been made by the board to date to recover the substantial losses incurred as a result of

the purchase and sale of Enron stock by its contracted, professional investment managers. However, the minutes of meetings since November 2001 did not indicate any course of action that the board has or plans to take in recouping any of its losses from its investments in Enron stock.

In response to our written inquiry on whether PRIM's position is considering action to recoup the losses incurred from the purchase and sale of Enron stock by its contracted investment managers, PRIM's Chief Financial Officer stated, "PRIM will participate in class action suits filed against Enron." However, our review of the minutes of board meetings did not indicate any discussion or board action to be taken on this matter.

Recommendation: PRIM should:

- Document, in board minutes to meetings, deliberations and decisions on significant matters, such as what course of action to take concerning Enron.
- Perform a complete accounting to determine the total amount of losses incurred from the purchase and sale of Enron stock by its contracted investment managers so that the actual total losses by the board is considered for recovery purposes in any legal action.
- Take an aggressive stand in recouping the funds lost from the purchase and sale of Enron stock by its contracted investment managers. The PRIM Board should determine and explore all legal options that are available to seek reimbursement for the losses incurred from its investments in Enron stock. This would include a determination on whether its contracted investment managers have been negligent in their management of Enron stock.

Moreover, in light of Enron-like accounting irregularities recently revealed at other major corporations (e.g., WorldCom, Inc.; Tyco International; Qwest Communications International, Inc.), it is imperative that the PRIM have a mechanism in place to monitor current market conditions to detect and immediately notify the board of potential high-risk corporate investments, so that the board can take action, when possible, to prevent investment losses. In this regard, the PRIM Board should immediately conduct a full review and accounting of all stock transactions and holdings in any such organizations in preparation for Commonwealth participation in potential class action suits.

SUPPLEMENTARY INFORMATION

1. ATTORNEY GENERAL'S OPINION REGARDING AUDIT AUTHORITY OF PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

On May 29, 2001, the Attorney General of the Commonwealth of Massachusetts issued an opinion stating that the Public Employee Retirement Administration Commission (PERAC) did not have the authority to review the procurement process adopted by the PRIM Board for the selection of investment managers or advisors, or to assess the results of such selections. The Attorney General's intervention was the result of a request in November 2000 by PERAC and the PRIM Board to clarify PERAC's authority with respect to reviewing PRIM's controls over the procurement of its investment managers and advisors, and became necessary when PRIM denied access to this specific information during PERAC's audit.

The Attorney General's opinion, which supported PRIM's position, was based on a provision in Chapter 32 of the General Laws, in which the Legislature exempted PRIM's investment policies from PERAC's rules and regulations that govern the investment of funds by all other retirement boards. Therefore, the Attorney General concluded, PERAC lacked authority to review the process adopted by PRIM for the selection of particular investment managers or advisors, or to assess the results of such selection. This position has restricted PERAC, the oversight agency responsible for monitoring the financial activities of all Massachusetts public pension systems, from reviewing investment decisions concerning the assets of those systems it oversees.

While recognizing that PRIM has an annual audit completed by a private accounting firm, we believe that independent government oversight is essential, particularly when billions of dollars in public pension funds are being managed by outside investors. Accordingly, we recommend that PERAC seek a legislative change to allow and require PERAC to review all aspects of PRIM's operations.

2. PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION AUDIT

PERAC completed a review of the PRIM Board for the period from January 1, 1994 to December 31, 1999 pursuant to Chapter 32, Section 21, of the General Laws. The report noted the following:

- Minutes of executive sessions for the calendar year 1994 could not be located and therefore were not available for inspection. Moreover, pages in the minutes' books were not sequentially numbered and the books were not bound. The PRIM Board had several vacant positions from 1994 to 1999. The report recommended that vacant positions be filled in a timely manner pursuant to 840 Code of Massachusetts Regulations 25.31(12).

3. MANAGEMENT OF THE PRIT PORTFOLIO

The board and staff of PRIM do not directly manage the assets of the PRIT Fund. The services of outside investment managers, pursuant to written contracts, are utilized to manage PRIT Fund assets. Each investment manager operates under a formal written contract that outlines its discretionary authority, liability, fee schedule, and appropriate performance expectations, including a formal set of investment objectives and guidelines and administrative requirements for the management of each portfolio. With regard to liability, the standard clause written in each Investment Management Agreement states:

The Manager shall not be liable for the selection of the Investment Objectives and Guidelines but shall be responsible for the management of the Account in accordance therewith and with such other instructions as PRIM may provide from time to time.... At all times the Manager shall exercise the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent expert acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. The Manager shall not be subject to liability for any act, omission or mistake of judgment in the course of, connected with, the performance of its responsibilities hereunder, except for its own negligence, willful misconduct or lack of good faith.

4. INVESTMENT FUNDS OF PRIT

PRIT consists of two investment funds, the "Capital Fund" and the "Cash Fund," each of which is managed, accounted for, and held separately by the custodian. Cash deposited and invested on a temporary basis is transferred monthly from the Cash Fund to the Capital Fund. Once in the Capital Fund, funds are generally invested and reinvested across all asset

classes according to the PRIM Board's long-term investment guidelines and asset allocation plan. The Capital Fund serves as the long-term asset portfolio and consists of the following 10 accounts as of December 31, 2001:

- General Allocation Account
- Domestic Equity
- Fixed Income
- International Equity
- Emerging Markets
- Core Real Estate
- Non-Core Real Estate
- Alternative Investments
- Alternative Investments Vintage Year 2000
- Alternative Investments Vintage Year 2001

The Cash Fund consists of short-term investments that are used to meet the liquidity requirements of Participating and Purchasing systems. The cash portfolios used by the State Teachers' Retirement System and the State Employees Retirement System receive daily deposits from various governmental employers that are members of the State Teachers' and State Employees retirement systems and are the source for benefit payments and operating expenses of those two retirement systems.

5. PRIM ASSET ALLOCATION PLAN

PRIM's asset allocation plan consists of a portfolio of domestic equity, international equity, fixed income securities, real estate, and alternative investments. The PRIM Board examines the asset allocation plan annually and undertakes a comprehensive review of the plan and its underlying assumptions, including the Commonwealth's current and projected pension

assets and liabilities, long-term capital markets rate of return assumptions, and the board's risk tolerances, at intervals of not more than three to five years.

The PRIM Board revisited the long-term asset allocation plan in January 2001. The PRIM Fund Asset Allocation Plan is as follows:

Domestic Equity	38%
International Equity	17%
Emerging Markets Equity	3%
Fixed Income	21%
High Yield Debt	3%
Real Estate	8%
Alternative Investments	10%

6. MONITORING OF INVESTMENT MANAGERS

The PRIM Board reviews the investment performance of the investment managers against their stated objectives at least quarterly. The managers' investment objectives and guidelines, which are part of each publicly traded securities and real estate manager's Investment Management Agreement, documents PRIM's performance expectations. The Investment Management Agreement establishes relative and absolute performance expectations. The manager is expected to perform in the top half of its peer universe over a three-to five-year period. Absolute performance expectations are a function of the efficiency of the asset class. The guidelines within the Investment Management Agreement delineate the investments and strategies the manager is permitted to use to achieve the performance objectives, as well as the investments and strategies it is prohibited from using.

PRIM has policies and procedures to monitor its contracted investment managers to determine whether there has been any deviation from PRIM investment guidelines and whether performance meets expectations. Monitoring policies and procedures of its investment managers include:

- Compliance certifications that are required to be sent to PRIM on a quarterly basis by the investment managers certifying that (a) the Manager has not deviated from the

Investment Guidelines set forth in the Investment Objectives and Guidelines and (b) the manager has not deviated from the requirements of Chapter 32, Section 23, of the General Laws concerning certain investments relating to South Africa, Northern Ireland, and tobacco. If the manager is unable to provide either of the certifications, the manager is required to provide PRIM with a detailed explanation.

- Quarterly reviews that are conducted for its publicly traded securities investment managers;
- Annual site visits that are conducted by PRIM staff of the investment managers' premises, and
- Portfolio reviews that are performed by PRIM staff.

During our audit, we reviewed PRIM's controls in place for monitoring its investment managers to contract terms. Our review revealed that PRIM has adequate controls in place to monitor its contracted investment managers that determine whether there has been any deviations from PRIM investment guidelines contained within the Investment Management Agreement.

7. PROCUREMENT OF INVESTMENT MANAGERS AND CONSULTANTS

To procure the services of outside investment managers and consultants, a Request for Proposals (RFP) is drafted by PRIM staff with the assistance of a consultant, when needed. The PRIM RFP document includes:

- The purpose of the RFP
- Background information on PRIM
- A definition of the scope of services to be provided
- Summary information of the PRIM's Board's legal structure and the PRIT Fund
- A request detailing information on all topics relevant to the services provided
- The selection criteria that will be used by PRIM to evaluate each proposal

Once it is reviewed and approved by the PRIM Board, the RFP is issued. A search committee composed of PRIM staff and consultants, where appropriate, reviews the

proposals received with decisions based on the selection criteria outlined in the RFP. The selection criteria that PRIM uses to evaluate proposals received include:

- Stability and general experience of the firm
- Quality and depth of the firm
- Client relations and references
- Performance and fees

The search committee forwards their evaluation of the selection process to the investment committee, which, with the assistance of a consultant provides the PRIM Board with a written recommendation of the selection process. The PRIM Board is provided with the report of the investment committee, including a review of the process, the names of finalists, and a recommendation, and PRIM accepts or rejects the recommendation. If the recommendation is accepted, the board delegates to the Executive Director the authority to carry it out. The PRIM staff then takes steps necessary to hire the service provider.

During our audit, we reviewed a sample of contracts awarded to investment firms and consultants to determine whether such contracts have been properly bid and awarded. Our review revealed that PRIM, for the contracts we tested, has complied with the provisions of Massachusetts procurement laws in the awarding of contracts to investment managers and consultants.

8. MANAGEMENT FEES

Expenses incurred by the PRIM Board in managing the PRIT Fund are charged to the fund in the form of management fees. (See Appendix VI.) These expenses consist of (a) investment management fees, (b) investment advisory fees, (c) custodian fees, and (d) other expenses, as discussed below.

a. Investment Management Fees

Investment management fees are paid to investment managers pursuant to written contracts. In most cases, equity managers are paid a base fee plus a performance fee component.

Performance fees are earned annually by those managers whose annualized three-year performance during their contract year exceeds the contractual benchmark by a specified minimum. Base fees are calculated and paid on a quarterly basis, whereas performance fees are paid to investment managers annually that outperform a contractual benchmark in the manager's Investment Management Agreement.

Investment management fees paid to investment managers for PRIM's fixed income, real estate, and alternative investments are as follows:

- Fixed income managers are generally paid on an asset based fee basis with no performance component.
- Separate account real estate relationships which PRIM has negotiated are typified by a base fee during the holding period of the investment, with a performance fee component that may be payable when the investment is sold.
- Fees for alternative investments are typically a percentage of committed capital with the fee percentage decreasing over time. Most investment management fees for alternative investments are charged to the general partners to the investment partnerships and not to the limited partner investors directly. Most investment management fees for real estate investments are charged directly to the property. Therefore, these investments incur expenses, pay fees, and report income net of those non-cash investment fees.

b. Investment Advisory Fees

PRIM investment advisors provide the PRIM Board with comprehensive pension investment advisory services that include:

- Recommendations on asset allocations
- Selection of investment managers
- Measurement of PRIT Fund performance
- Measurement of investment managers' performance

During our audit period, Wilshire Associates, Inc; The Townsend Group; and Pathway Capital Management, LLC served as PRIM's principal pension investment advisors.

c. Custodian Fees

PRIM utilizes the services of a custodian that provides PRIM with the following services:

- Recording the daily transactions of the PRIT Fund, including investment sales and purchases, investment income, and expenses incurred by PRIT
- Analyzing portfolio performance
- Holding the assets of the PRIT Fund
- Accounting for and assisting in the settlement of all transactions executed by PRIM's investment managers
- Providing information on the holdings, transactions, and performance of the PRIT Fund

During our audit, Mellon Trust was the PRIM-contracted investment custodian and record keeper.

d. Other Expenses

PRIM's remaining other management expenses consist of reimbursements and accruals of operating expenses, which include employee compensation, professional fees, and occupancy costs of the PRIM Board.

During our audit, we reviewed and tested investment fees paid to PRIM's contacted investment managers to determine whether such fees were in compliance with contractual terms. Our review revealed that fees paid to PRIM's contracted investment managers were in compliance with contractual terms.

APPENDIX I**Listing of the Member Participating
Retirement Systems of the PRIT Fund, as of
December 31, 2001**

- | | |
|---|--------------------------------|
| 1. Berkshire County | 10. Montague |
| 2. Blue Hills Regional Vocational
School | 11. Needham |
| 3. Dedham | 12. Northbridge |
| 4. Easthampton | 13. Reading |
| 5. Fairhaven | 14. State Employees Retirement |
| 6. Gardner | 15. State Teachers |
| 7. Hingham | 16. Saugus |
| 8. Milton | 17. Stoneham |
| 9. Minuteman Regional Vocational
Technical School District | 18. Wakefield |
| | 19. Weymouth |

APPENDIX II**Listing of the Member Purchasing Retirement
Systems, as of December 31, 2001**

- | | |
|----------------------|---|
| 1. Barnstable County | 13. Massachusetts Water Resources Authority |
| 2. Belmont | 14. Mass Port Authority |
| 3. Braintree | 15. New Bedford |
| 4. Brookline | 16. Newburyport |
| 5. Chicopee | 17. Plymouth |
| 6. Concord | 18. Quincy |
| 7. Dukes County | 19. Revere |
| 8. Framingham | 20. Shrewsbury |
| 9. Greenfield | 21. Webster |
| 10. Hull | 22. Wellesley |
| 11. Leominster | 23. Woburn |
| 12. Marblehead | |

APPENDIX III

Pension Reserves Investment Trust Fund (PRIT) Financial and Performance Summary
July 1, 1996 to December 31, 2001

	December 31, 2001*	June 30, 2001	June 30, 2000	June 30, 1999	June 30, 1998	June 30, 1997
Total Assets	\$ 30,300,026,852	\$ 30,458,358,761	\$ 32,638,408,762	\$ 27,850,135,332	\$ 24,852,029,826	\$ 20,604,363,594
Total Liabilities	\$ (1,507,008,704)	\$ (1,030,719,135)	\$ (1,105,238,805)	\$ (765,706,650)	\$ (899,327,917)	\$ (493,490,616)
Total Net Assets	\$ 28,793,018,148	\$ 29,427,639,626	\$ 31,533,169,957	\$ 27,084,428,682	\$ 23,952,701,909	\$ 20,110,872,978
Operating Expenses as % of Fund	0.21%	0.38%	0.32%	0.29%	0.27%	0.33%
One-Year Return	-5.32%	-6.60%	16.13%	12.67%	17.53%	21.78%
Interim Policy Benchmark	-7.08%	-9.04%	9.92%	14.78%	17.25%	20.00%
Over/(Under) Benchmark	1.77%	2.44%	6.21%	-2.11%	0.28%	1.78%
Average Annual Return Since Inception	11.32%	11.91%	13.22%	12.99%	13.05%	12.70%
Long-Term Actuarial Rate of Return**	8.25%	8.25%	8.25%	8.25%	8.25%	8.25%
Over/(Under) Long-Term Assumed Actuarial Rate of Return Since Inception	3.07%	3.66%	4.97%	4.74%	4.80%	4.45%

* Note: The financial activity for the six months ended December 31, 2001 was unaudited.

** The actuarial rate of return assumed by the state pension funding schedule to meet the then-existing pension obligations of the Commonwealth by 2018.

APPENDIX IV

Ranking and Performance of the PRIM Board, Five Years Ended December 31, 2001

	Five-Year Period 1997-2001*		Year Ended December 31, 2001*		Year Ended December 31, 2000		Year Ended December 31, 1999		Year Ended December 31, 1998		Year Ended December 31, 1997	
	Return	Rating	Return	Rating	Return	Rating	Return	Rating	Return	Rating	Return	Rating
PRIM Board	9.41%	45	-5.32%	86	-1.2%	92	23.25%	14	14.84%	59	18.43%	68
Total Mass. Boards Reporting		107		107		107		107		107		107

Note: This information was obtained from the Public Employee Retirement Administration (PERAC). The Massachusetts retirement boards report their performance returns to PERAC on a calendar-year, rather than a fiscal-year, basis. The information is presented to illustrate how the PRIM Board has performed in comparison to the Massachusetts retirement boards.

*The financial activity for the six months ended December 31, 2001 is unaudited.

APPENDIX V
Comparison of Budget to Actual Financial Amounts
 July 1, 1999 to December 31, 2001

Description	Period Ended December 31, 2001*			Period Ended June 30, 2001			Period Ended June 30, 2000		
	YTD Actual 12/31/2001	YTD Budget 12/31/2001	Variance Favorable/ (Unfavorable)	YTD Actual 6/30/2001	YTD Budget 6/30/2001	Variance Favorable/ (Unfavorable)	YTD Actual 6/30/2000	YTD Budget 6/30/2000	Variance Favorable/ (Unfavorable)
Investment Management Fees									
Domestic Equity	\$ 12,787,400	\$ 13,772,438	\$ 985,038	\$ 23,307,000	\$ 21,018,227	\$ (2,290,773)	\$ 19,269,952	\$ 15,382,043	\$ (3,887,909)
International Equity	11,884,523	13,406,188	1,521,645	24,293,798	25,272,901	979,103	24,728,944	13,827,733	(10,899,211)
Fixed Income	4,530,684	5,247,238	716,554	11,487,435	11,340,701	(146,734)	9,929,040	10,012,051	83,011
Emerging Markets	1,393,327	2,151,736	758,409	3,202,211	3,812,405	610,194	3,693,069	2,088,215	(1,624,854)
Real Estate	428,248	451,292	23,044	788,159	1,335,149	546,990	735,702	1,312,500	576,798
Alternative Investments	2,467,766	2,206,158	(261,608)	2,412,762	4,999,113	2,586,351	3,095,264	4,511,938	1,415,674
Subtotal	\$ 33,491,948	\$ 37,235,030	\$ 3,743,082	\$ 65,491,365	\$ 67,776,496	\$ 2,285,131	\$ 61,450,971	\$ 47,114,480	\$ (14,336,491)
Custody & Outside Advisors									
Custodian	\$ 550,000	\$ 575,000	\$ 25,000	\$ 1,078,679	\$ 1,150,000	\$ 71,321	\$ 1,100,000	\$ 1,250,000	\$ 150,000
Consultant - Overall	265,502	284,000	18,498	401,092	549,750	148,658	463,750	461,000	(2,750)
Consultant - Alternative Investment	699,996	775,000	75,004	1,253,118	891,250	(361,868)	795,417	756,250	(39,167)
Consultant - Real Estate	71,000	92,500	21,500	143,875	160,000	16,125	173,025	225,000	51,975
Accounting	88,000	108,000	20,000	270,293	212,500	(57,793)	230,542	210,000	(20,542)
Legal	210,105	137,500	(72,605)	450,932	275,000	(175,932)	149,748	275,000	125,252
Actuarial	40,063	122,500	82,437	85,125	90,000	4,875	80,125	85,000	4,875
Corporate Governance	1,924,666	2,094,500	169,834	3,683,114	3,328,500	(354,614)	2,988,019	3,312,250	324,231
Subtotal	\$ 789,982	\$ 941,000	\$ 151,018	\$ 1,299,872	\$ 1,413,000	\$ 113,128	\$ 1,091,971	\$ 1,300,000	\$ 208,029
Operations									
Salaries	126,887	128,350	1,463	237,320	256,700	19,380	161,832	154,000	(7,832)
Occupancy	58,881	59,750	869	110,098	107,200	(2,898)	106,745	132,600	25,855
Insurance	13,936	17,375	3,439	32,676	41,130	8,454	23,810	36,500	12,690
Benefits	27,793	74,300	46,507	84,494	86,200	1,706	164,320	86,200	(78,120)
Office Expenses	47,523	100,000	52,477	85,502	200,000	114,498	129,293	200,000	70,707
Computer & MIS Expenses	25,256	34,999	9,743	39,603	70,000	30,397	29,998	70,000	40,002
Due Diligence Travel	18,876	25,000	6,124	51,361	50,000	(1,361)	37,143	50,000	12,857
Board/Staff Fiduciary Education	5,351	22,500	17,149	44,225	45,000	775	40,908	37,400	(3,508)
Client Services	5,733	7,000	1,267	17,459	14,000	(3,459)	15,536	14,000	(1,536)
Dues and Subscriptions	9,750	1,000	(8,750)	10,685	2,000	(8,685)	-	2,000	2,000
Temporary Labor	1,129,968	1,411,274	281,306	2,013,295	2,285,230	271,935	1,801,556	2,082,700	281,144
Subtotal	\$ 3,054,634	\$ 3,505,774	\$ 451,140	\$ 5,696,409	\$ 5,613,730	\$ (82,679)	\$ 4,789,575	\$ 5,394,950	\$ 605,375
Total Operations & Advisors	\$ 36,546,582	\$ 40,740,804	\$ 4,194,222	\$ 71,187,774	\$ 73,390,226	\$ 2,202,452	\$ 66,240,546	\$ 52,509,430	\$ (13,731,116)
Total Fees & Expenses Paid by PRIM									
Fees Recorded by PRIM	3,918,256	7,987,500	4,069,244	11,386,567	15,420,000	4,033,433	7,362,397	15,310,000	7,947,603
Real Estate	20,391,678	23,336,142	2,944,464	33,734,304	25,445,416	(8,288,888)	21,587,941	22,017,430	430,089
Alternative Investments	\$ 24,309,934	\$ 31,323,642	\$ 7,013,708	\$ 45,120,871	\$ 40,865,416	\$ (4,255,455)	\$ 28,949,738	\$ 37,327,430	\$ 8,377,692
Subtotal	\$ 60,856,516	\$ 72,064,446	\$ 11,207,930	\$ 116,308,645	\$ 114,255,642	\$ (2,053,003)	\$ 95,190,284	\$ 89,836,860	\$ (5,353,424)

Note: The financial activity for the six months ended December 31, 2001 is unaudited.

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APPENDIX VI (Continued)
FEES PAID TO INVESTMENT MANAGERS
July 1, 1999 to December 31, 2001

Investment Manager	Six Months Ended: 12/31/01*		Year-To-Date		Twelve Months Ended: 06/30/01		Year-To-Date		Twelve Months Ended: 06/30/00		Year-To-Date	
	Base	Performance	Accruals	Base	Performance	Accruals	Base	Performance	Accruals	Base	Performance	Accruals
EMERGING MARKETS												
Emerging Markets	\$ 281,700.00	\$ 899,353.00	\$ 1,181,053.00	\$ 557,987.00	\$ 2,197,373.00	\$ 2,755,360.00	\$ 527,632.00	\$ 2,697,871.00	\$ 3,225,503.00	\$ 467,566.00	\$ 2,697,871.00	\$ 3,225,503.00
Schroder Capital Management	212,274.11	0.00	212,274.11	446,850.80	0.00	446,850.80	467,566.00	0.00	467,566.00	0.00	0.00	467,566.00
	<u>\$ 493,974.11</u>	<u>\$ 899,353.00</u>	<u>\$ 1,393,327.11</u>	<u>\$ 1,004,837.80</u>	<u>\$ 2,197,373.00</u>	<u>\$ 3,202,210.80</u>	<u>\$ 995,198.00</u>	<u>\$ 2,697,871.00</u>	<u>\$ 3,693,069.00</u>	<u>\$ 467,566.00</u>	<u>\$ 2,697,871.00</u>	<u>\$ 3,693,069.00</u>
REAL ESTATE INV. TRUSTS												
RREEF America	\$ 87,500.00	\$ 104,521.00	\$ 192,021.00	\$ 175,000.00	\$ 176,410.00	\$ 351,410.00	\$ 175,000.00	\$ 200,693.00	\$ 375,693.00	\$ 360,009.00	\$ 200,693.00	\$ 360,009.00
John McStay Investment	236,227.00	0.00	236,227.00	436,749.00	0.00	436,749.00	360,009.00	0.00	360,009.00	0.00	0.00	360,009.00
	<u>\$ 323,727.00</u>	<u>\$ 104,521.00</u>	<u>\$ 428,248.00</u>	<u>\$ 611,749.00</u>	<u>\$ 176,410.00</u>	<u>\$ 788,159.00</u>	<u>\$ 535,009.00</u>	<u>\$ 200,693.00</u>	<u>\$ 735,702.00</u>	<u>\$ 360,009.00</u>	<u>\$ 200,693.00</u>	<u>\$ 735,702.00</u>
TOTAL PUBLIC MARKETS	<u>\$ 11,566,319.98</u>	<u>\$ 19,457,859.88</u>	<u>\$ 31,024,179.86</u>	<u>\$ 22,915,668.37</u>	<u>\$ 40,162,932.64</u>	<u>\$ 63,078,601.01</u>	<u>\$ 20,903,475.32</u>	<u>\$ 37,451,231.79</u>	<u>\$ 58,354,707.11</u>	<u>\$ 58,354,707.11</u>	<u>\$ 37,451,231.79</u>	<u>\$ 58,354,707.11</u>
Real Estate Incentive Fees	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>\$ 2,665,961.00</u>	<u>\$ 2,665,961.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>

*see note below

*Note: The financial activity for the six months ended December 31, 2001 is unaudited