THE COMMONWEALTH OF MASSACHUSETTS
OFFICE OF THE INSPECTOR GENERAL

THE PROCUREMENT OF PENSION INVESTMENT MANAGEMENT SERVICES BY THE DEPARTMENT OF THE STATE TREASURER

Robert A. Cerasoli
Inspector General
August, 1993

The Commonwealth of Massachusetts

Office of the Inspector General

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August, 1993

His Excellency Governor William F. Weld

The Honorable Senate President William M. Bulger

The Honorable Speaker of the House Charles F. Flaherty

Members of the General Court

Omnibus ad quos praesentes literae pervenerint, salutem.

I am today releasing a report on the procurement of pension investment management services by the Department of the State Treasurer. The report documents my findings, conclusion, and recommendations for reform.

This procurement was reviewed as part of my Office's ongoing examination of the largely unregulated area of financial services contracting. The informal, idiosyncratic process by which many public entitites award lucrative financial service contracts exposes these procurements to waste and favoritism. My Office will continue its work in this important and highly vulnerable area of public contracting.

Sincerely,

Robert A. Cerasoli

Robert A. Cerasoli
Inspector General

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INTRODUCTION

In the summer of 1991, employees of the Department of the State Treasurer (Department) undermined a competitive request for proposals (RFP) process by awarding contracts to invest $595 million in pension funds to six firms which failed to qualify under established RFP rules. Later, in the wake of press criticism that the process had yielded a "phony competition" resulting in favored treatment of one investment firm, employees created material which conveyed the appearance that a valid competitive selection process had been conducted.

Evidence reviewed by the Office of Inspector General (OIG) shows that Department employees allowed certain investment firms to circumvent the RFP rules by submitting late proposals, remaining in the competition after having been disqualified by the rules, using imaginary investment performance records, and exaggerating investment performance history. In the case of one favored firm, the Department created a special category in which the firm could compete unopposed.

When the Department issued the RFP in May 1991, it announced that contracts would be awarded on the basis of "an open, fair, competitive process." The RFP stipulated that firms not meeting all of the minimum criteria "shall be rejected," proposals not meeting the deadline "will not be considered," and that candidates "must meet the . . . performance criteria" to qualify. The records reviewed by the OIG show, however, that the Department abandoned these rules and awarded contracts without regard to fair competition or to the qualifications of competing firms.

The Department afforded favored treatment to six investment firms which did not meet minimum qualifications for this competition.

- Records show that the Department was informed by **Goldman Sachs Asset Management (GSAM)** prior to the award of the contract that the firm did not meet the minimum requirements for the competition, yet Department officials awarded this favored firm a contract to manage $100 million with effective annual fees of $400,000. The Department also apparently created a special investment category in which GSAM had no competition.

- **Massachusetts Financial Services (MFS)** was awarded a contract to manage $160 million with effective annual fees of more than $550,000, despite its failure to meet minimum performance standards established in the RFP. An analysis of the Department's pension fund managers prepared in February 1991, by its investment consultant, Callan Associates Inc. (Callan), reported a previous investment history for MFS which failed to meet any of the five minimum RFP performance requirements. Callan's February 1991 analysis also showed that MFS ranked in the bottom 16 percent of investment managers in Callan's national database over the previous five-year period. In contrast, one of the firms losing to MFS in the competition had been ranked by Callan among the top 1 percent of investment managers nationwide over the same five-year period.

- **Numeric Investors l.p. (Numeric)** was allowed to submit its proposal three weeks after the RFP deadline and won a contract despite its failure to meet minimum standards for years of experience and volume of assets under management. The RFP required a five-year history and a minimum of $300 million currently under management in the specialty product. Numeric had managed only one account valued at $5.6 million in the specialty product (less than 2 percent of the required minimum) and had managed the account for less than two months prior to responding to the RFP.

- Other firms which received contracts after having failed to meet the RFP requirements include **Greaves Capital Management (Greaves), Equitable Capital Management (Equitable)**, and **Morgan Stanley Asset Management (Morgan Stanley)**. In addition, a seventh firm, **Chancellor Capital Management (Chancellor),** received a contract despite its failure to submit performance results consistent with those required, making it impossible to determine if the firm had met the standards of the RFP.

After criticism was raised in regard to these contract awards, the Department instructed its consultant, Callan, to create backdated documents which conveyed the appearance that a valid competition had occurred.

- Months after the contract awards were made, Callan employees prepared reports on the performance of the winning investment firms and attached backdated, signed cover letters which gave the impression that the reports had been created contemporaneously with the RFP process.

- Two Deputy Treasurers initially represented to the OIG that one of these reports, dated May 1991 and bearing a 1991 copyright notation, had been used during the proposal process. This report contained information which could not have been available in May, 1991, such as the results of Numeric's proposal, which was not received until June 13, 1991. Attorneys representing the Department later told the OIG that this report had actually been created in the summer of 1992. Backdating this report gave the misleading impression that Numeric's proposal had been submitted prior to the May 24, 1991 deadline. The report also contained misleading information about the performance of some firms.

The Department's disregard for its own standards in the selection of investment managers appears to have harmed the State employees' and teachers' pension fund.

- According to performance results reported by the top-ranked investment firms which competed for contracts but were not selected, the retirement fund would have earned between $44.8 million and $59.7 million more during the eighteen-month period following the selection process had the Department simply awarded contracts in accordance with the RFP rules.

The OIG's review of a later procurement of global fixed-income investment management services revealed a similar pattern of favored treatment by the Department.

- The Department conducted another competition for global fixed-income investment management services between November 1991 and March 1992. Two of the three managers selected in this competition, MFS and Scudder, Stevens & Clark (Scudder), did not meet the minimum performance standards of the RFP. Nevertheless, the Department informed the Pension Investment Committee, the State board responsible for approving pension investments, that these two firms had met all of the RFP requirements.

BACKGROUND

The Office of the Inspector General conducted an investigation of the Department's 1991 procurement of investment firms to provide domestic equity management services for the MASTERS Trust. The MASTERS Trust is the combined investment fund for State employees' and State teachers' retirement annuities. Massachusetts General Laws, Chapter 32, Section 23, establishes an unpaid pension investment committee (PIC) to oversee the MASTERS Trust. The committee is composed of three members: the Treasurer ex-officio, who serves as Chairman; the Commissioner of Banks, ex officio; and a third member, with investment experience, elected by the other two. The Treasurer has authorized the Deputy Treasurer in charge of the Pension Investment Division (PID) to act on his behalf. The PID is the unit within the Department which has the statutory responsibility for the investment of the State employees' retirement funds, and upon the request of the teachers' retirement board, also has the responsibility for the investment of their funds.

The duties of the PIC are "general supervision of the investment and reinvestment" of the Trust. The Treasurer has day to day administrative responsibility as the State official in charge of the management of these funds. However, the statute makes the investment and reinvestment of funds subject to the PIC's approval "in each instance."

M.G.L. c.32, §23, requires the Treasurer and the other two members of the PIC, as persons who exercise discretionary authority over the management of the assets of the State retirement system pursuant to M.G.L. c.32, §1, to meet a fiduciary standard of conduct. Section 23 (3) states:

> A fiduciary. . . shall discharge his duties for the exclusive purpose of providing benefits to members and their beneficiaries with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in

> a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims and by diversifying the investments of the system so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

The purpose of this provision is to ensure that the Treasurer, together with the other two members of the PIC, takes all the steps necessary to generate income from the principal of the MASTERS Trust while minimizing the risk of loss of capital.

The principles of fiduciary conduct articulated in the Massachusetts common law of trusts and Section 404 (a)(1)(A, B) of the federal Employee Retirement Income Security Act of 1974 (P.L. 93-406), also known as ERISA, are useful guides in understanding the behavior expected of the PIC in its management of State employees' and teachers' retirement funds. State judicial decisions regarding the management of trust funds and federal court rulings in the context of the management of private employer retirement funds permit trustees to rely on outside investment managers to invest these funds. However, the expectation is that trustees of a pension fund will "show a record of search for managers whose investment philosophy and performance record have been consistent with the needs and objectives of the pension plan's written objectives."[1]

The Department, consistent with its fiduciary obligation to act in a sound and prudent manner, issued an RFP for investment managers in May 1991. This RFP established well-defined search and selection procedures and minimum standards on which the PIC could rely in making its decisions. According to former State Banking Commissioner Michael Hanson, then a PIC member, the Department informed the PIC that the selection of investment managers was being conducted by this competitive RFP process.[2] Mr. Hanson stated that the Department officials gave him assurances prior to his approval of the Department's investment manager selections that

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[1]W. Terence Jones and Steven W. Hiorns, "Meeting The ERISA Rules of Fiduciary Responsibility, Massachusetts Lawyers Weekly, 21 (April 5, 1993) 29: Supplement, 8.

[2]Michael Hanson, Esq. Interview under oath with the staff of the Office of the Inspector General (OIG), (April 12, 1993): 10.

they had conducted the RFP process appropriately and that every manager selected met the RFP requirements.[3] Mr. Hanson stated that as a fiduciary to MASTERS, he relied upon statements made by the staff of the Department in regard to the procedure followed in the selection of these managers.[4]

The Department employed an investment consulting firm, Callan, which was paid by the MASTERS Trust. Callan, under contract to the Department since 1989, provided search and screening services for investment managers. Callan's duties, under an optional provision of its contract, included the development of "appropriate criteria prior to any search;" selection of a "group of candidates from a preliminary list" drawn from its database; the preparation of "a search report comparing candidates;" and participation in interviews with finalists if requested by the Trust, as well as advice in the "final selection process."[5]

The terms of Callan's contract made the firm subject to fiduciary obligations "when providing consulting services," and "a co-fiduciary with the Trustee of MASTERS and with the Investment Committee with respect to any action taken by the Trustee or the Investment Committee, respectively, based upon recommendations of Callan."[6] The Treasurer is the Trustee of the MASTERS Trust.[7]

The MASTERS Trust paid Callan $20,000, in July 1991, in addition to annual fees totalling $180,000, for its "core consulting services." Callan's core services included general

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[3]Hanson. Interview with the OIG: 39, 23.

[4]Hanson. Interview with the OIG: 40-41.

[5]Callan Associates Inc. and Massachusetts Teachers' & Employees' Retirement Systems Trust, Agreement For Investment Consulting Services, (July 31, 1990): 3.

[6]Ibid.

[7]Commonwealth of Massachusetts, The Massachusetts State Teachers And Employees Retirement Systems Trust, Operating Trust as of January 1, 1989, Robert Q. Crane, Trustee, Files of the Department.

consulting services ($40,000 per year), quarterly performance measurement reports ($100,000 per year), and quarterly real estate evaluations ($40,000 per year).[8]

[8]Callan Associates Inc. (Callan), Agreement, (July 31, 1990): 4.

FINDINGS

The OIG's examination involved the review of hundreds of documents pertaining to the procurement of investment managers, as well as interviews with a number of former and present State officials. The OIG found that the employees of the Department mismanaged the selection of domestic equity managers, disregarded their own self-imposed standards for the appointment of these managers, and failed to follow the prudent and rational process which they had developed and which the public and the members of the retirement system had a right to expect. The OIG's findings are as follows:

Finding 1: The Department subverted its own competitive process for the selection of domestic equity investment managers.

> **Finding 1a: The Department disregarded procedural rules designed to ensure genuine and fair competition.**
>
> **Finding 1b: The Department selected managers which did not meet the minimum criteria contained in the RFP for experience and performance.**

Finding 2: The Department apparently failed to inform the Banking Commissioner that investment managers for the MASTER's Trust were selected without regard for the rules and standards set forth in the RFP.

Finding 3: On two separate occasions, the Department and its consultant, Callan, backdated documents created after the award of the contracts, in an apparent attempt to justify the managers that were selected.

Finding 4: The Department did not adequately use the services of its consultant, Callan.

Finding 5: The Department sacrificed additional earnings of at least $44.8 million by violating the RFP rules.

Finding 6: The Department disregarded the minimum performance criteria in a later RFP for the procurement of global fixed-income investment managers.

DISCUSSION OF FINDINGS

Finding 1: The Department subverted its own competitive procurement process for the selection of domestic equity investment managers.

The Treasurer established the MASTERS Trust in 1989, pursuant to M.G.L. c.29, §38A, merging three separate trust funds into one investment vehicle for the State teachers' and employees' retirement funds. The Trust is a broadly diversified portfolio, which stood at $5.532 billion at the end of February 1991.[9] Domestic equity funds comprised $1.543, billion, about 28 percent of the total portfolio at that time.[10] Twelve managers reflecting four different equity styles (i.e., growth, value, core, small cap) shared responsibilities for investing approximately $1 billion.[11] The PID managed the balance, $.557 billion, in an index fund designed to mirror the S&P 500.[12]

The Department conducted three days of meetings in March 1991 with the twelve existing managers holding contracts to manage equity funds for the MASTERS Trust.[13] On April 23,

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[9]State Street Analytics, M.A.S.T.E.R.S. Executive Summary Report for Period Ending February 28, 1991, (March 21, 1991): Table 1, "M.A.S.T.E.R.S. Trust Plan/Pool Allocation For Period Ending February 28, 1991," Files of the Massachusetts Division of Banks (MSD).

[10]Ibid.

[11]State Street Analytics, M.A.S.T.E.R.S. Executive Summary Report,Table 3, "M.A.S.T.E.R.S. Trust Comparative Rates of Return For Period Ending February 28, 1991," Files of the MSD.

[12]Ibid.

[13]Mark Baker, Chief Investment Analyst, Pension Investment Division (PID), Department of the State Treasurer. Internal memorandum to Steven Kaseta, Deputy Treasurer, concerning the "Domestic Equity Search, May - August, 1991," (Undated): 1, Files of the Department of the State Treasurer.

1991, the Deputy Treasurer in charge of the PID, Steven Kaseta, announced to the members of the PIC that the Department would issue a Request for Proposal (RFP) to domestic equity managers. Referring to the total number of managers, including real estate, fixed income, international stock portfolio and venture capital, he stated:

> There are presently sixty-one outside money managers. The objective is to trim the number of managers while creating a more efficient structure without affecting the overall diversification of the fund.[14]

Implicit in the fiduciary standard is the requirement that the Department will establish procedures which will enable the agency to proceed with care, skill, prudence and diligence in the choice of investments. Reliance on professional managers to select investments is a well accepted method to fulfill this fiduciary obligation.

The Department issued an RFP on May 6, 1991, with proposals due by May 24, 1991, for the selection of managers to provide services in three disciplines: growth, value, and small capitalization.[15] The Department received 60 proposals from 56 firms in response to its RFP, including twelve firms which then held contracts with MASTERS.

The selection committee held oral interviews on June 13, 14, 19, and 20, of 1991, with the twelve finalists chosen by the selection committee from the 56 firms that submitted proposals. None of the these twelve finalists had MASTERS contracts. The selection committee consisted of Deputy Treasurer Kaseta, Mark Baker who was the Chief Investment Analyst for the PID, and Gordon Dickinson, Senior Vice President, Callan.

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[14]Commonwealth of Massachusetts, State Employees' Annuity Fund and Teachers' Annuity Fund, Investment Committee Meeting (PIC), (April 23, 1991): 2 (#8).

[15]Department of the State Treasurer (Department), Request for Proposal (RFP) To Perform Investment Management Services For The Commonwealth of Massachusetts, (May 6, 1991): 1.

Although the Department required its twelve existing money managers to respond to the RFP in order to compete for a contract award, the selection committee did not meet with any of these firms after they had submitted their proposal. Prior to the competition, in March 1991, the PID had conducted meetings with all of the domestic equity managers under contract with MASTERS.[16] A memorandum, prepared by Callan in April of 1991, on the upcoming search for domestic equity managers, stated that the Department planned to terminate three large cap growth managers along with two large cap value managers, which it named.[17]

According to an internal report, the Department had decided "to be fair and equitable to the current managers and the potential managers, the current managers could be invited to submit new proposals on the same basis as all other potential managers who are also submitting proposals."[18]

Regardless of its original intentions, or of the rules set forth in the RFP, the Department appears to have conducted two separate competitions, one in the shadow of the other. The Department held one competition for the twelve existing managers, which resulted in seven firms being terminated, and another, larger competition for the 44 other firms which had responded to the RFP.

The Department's files indicate that Deputy Treasurer Kaseta sent out rejection letters to the losing candidates in mid-July. (See Exhibit A on the following page for a list of the firms receiving contract awards and the amount of the allocation of plan assets.)

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[16]Baker, Department. Internal memorandum concerning the "Domestic Equity Search, May - August, 1991," (Undated): 1, Files of the Department.

[17]Callan, "Massachusetts Teachers' and Employees' Retirement System Client Profile," (April 1991): 1, Files of Callan).

[18]Baker, Department. "Domestic Equity Search, May - August, 1991," (Undated): 3, Files of the Department

Exhibit A

COMPLETE LIST OF DOMESTIC EQUITY MANAGERS

NEW DOMESTIC EQUITY MANAGERS

THE BOSTON COMPANY INSTITUTIONAL INVESTORS, INC.	AMOUNT ALLOCATED $160 MILLION - 8/91
CHANCELLOR CAPITAL MANAGEMENT	AMOUNT ALLOCATED $160 MILLION - 8/91
FIDELITY MANAGEMENT TRUST COMPANY	AMOUNT ALLOCATED $160 MILLION - 8/91
GOLDMAN SACHS ASSET MANAGEMENT	AMOUNT ALLOCATED $100 MILLION - 8/91
NUMERIC INVESTORS, L.P.	AMOUNT ALLOCATED $25 MILLION - 8/91

DOMESTIC EQUITY MANAGERS RETAINED

	CURRENT AMOUNT UNDER MANAGEMENT 8/91
EQUITABLE CAPITAL MANAGEMENT	$160,241,395.85
GREAVES CAPITAL MANAGEMENT	$ 50,407,856.97
INDEPENDENCE INVESTMENT ASSOC., INC.	$200,409,469.89
MASSACHUSETTS FINANCIAL SERVICES	$160,169,440.95
MORGAN STANLEY ASSET MANAGEMENT	$ 99,896,155.15
PID INDEX	$605,165,822.85

Source: Office of the Treasurer

Note: The Pension Investment Division (PID) Manages an Index Fund for the Masters Trust

Finding 1a: The Department disregarded procedural rules designed to ensure genuine and fair competition.

The purpose of the RFP was to establish a level playing field for all competitors in order to ensure that the State selected the best proposal, while avoiding favoritism and bias. The Department's RFP mandated certain specifications in order to have the Department consider a proposal:

- The RFP contained a firm deadline date of May 24, 1991, for the delivery of proposals.[19]

- The RFP required a separate proposal for each of the three styles of management identified earlier (growth, value, and small capitalization).[20]

- The RFP required that the submission be accompanied by a cover letter "which shall be considered an integral part of the proposal, shall be signed by the individual(s) who is (are) authorized to bind the firm contractually . . . ." The RFP also stated, "The letter shall contain a statement to the effect that the proposal is a firm and irrevocable offer . . . ." Finally, the RFP stated, "A separate attachment to the cover letter must contain a list of the minimum qualifications and a signed statement certifying that the firm meets all of the minimum qualifications."[21]

The Department allowed two firms to submit proposals after the deadline. The Department selected these firms to receive contracts to manage funds even though they applied after the deadline date of May 24, 1991. Chancellor, which filed its proposal on May 27, 1991,

[19]Department, Request for Proposal (RFP), (May 6, 1991): 3.

[20]Ibid.

[21]Ibid.

received a contract to manage $160 million in retirement plan assets.[22] Numeric met with Deputy Treasurer Kaseta on May 23, 1991, the day before the final filing date for proposals.[23] Following this meeting, Numeric submitted a proposal to the Department which was received on June 13, 1991. Despite missing the cut-off date, Numeric was awarded a contract to manage $25 million in plan assets.[24]

The Department apparently created a special category in which one firm, Goldman Sachs Asset Management, had no competition. The RFP specifications included a provision which stated: "A separate RFP for each of the three styles of management identified earlier (growth, value, small-capitalization) must be submitted."[25] The Department bent this rule for GSAM, allowing it to submit one proposal to manage three different stock portfolios: growth, value, and small capitalization.

GSAM stated in its cover letter dated May 23, 1991:

> While your RFP requests three proposals to be submitted, GSAM is submitting one consolidated proposal for all three investment approaches due to the redundancy in much of the organizational and investment process materials.[26]

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[22]Department, Log entitled "Date Received," Files of the Department. This log shows that the Office received Chancellor Capital Management's (Chancellor) proposal on 5/27/91.

[23]Numeric Investors l.p. (Numeric), An Introduction To The Firm And Its Quantitative Investment Strategies, A Presentation to Steven Kaseta, Deputy Treasurer, Massachusetts State Teachers and Employees Retirement Plan, (May 23, 1991), Files of Numeric.

[24]Department, Log, Files of the Department. This log shows that the Department received Numeric's proposal on 6/13/91.

[25]Department, RFP, (May 6, 1991): 3.

[26]Alan A. Shuch, Partner, Goldman, Sachs & Co., Asset Management Division, President and Chief Operating Officer. Letter to Steven J. Kaseta, May 23, 1991, Files of the Department.

GSAM received a contract to manage $100 million in MASTERS Funds. What is unclear is the type of portfolio style that GSAM competed to manage. Callan's evaluation of the finalists for domestic equity manager dated May 1991, although prepared more than a year later, identified GSAM as a manager with a "core equity style."[27] According to this Callan document, GSAM's "[e]nhanced Core product is quantitatively based and invests in a broad list of U.S. traded securities with the goal of outperforming the S&P index."[28]

Deputy Treasurer Kaseta, in an interview with the OIG on November 25, 1992, disputed Callan's classification of the GSAM product. Mr. Kaseta told the OIG that GSAM competed to manage a large cap value portfolio. He said that Callan had erroneously put GSAM into a style category, core equity, that was not sought by the MASTERS RFP. If Callan's version were correct, GSAM had no competition in the core category, while twenty one other managers competed to manage a "Large Capitalization - Value" portfolio.

The Department subsequently provided other documents to the OIG which suggest that it did not, as the Deputy Treasurer had asserted, evaluate GSAM as a large cap value manager. For example, the Department provided an undated schedule of the oral interviews with thirteen finalists held in June 1991 which put GSAM by itself into the "core" category.[29] There was a thirteenth finalist, also under the typewritten heading of "core," Chestnut Hill Management Company (CHMC), but a handwritten note dated November 2, 1992, states that CHMC was "not considered for (the) core position" and was "interviewed for informational purposes."[30] The schedule described above contradicted the version of the oral interview schedule previously

[27]Callan, <u>Massachusetts Teachers' and Employees' Retirement System Investment Manager Evaluation-Equity</u>, (May 1991): 59.

[28]Ibid.

[29]Department, "Domestic Equity Firms Selected for Oral Presentations," (Undated), Files of the Department. The Department provided this document to the OIG on February 16, 1993.

[30]Ibid.

provided to the OIG by Deputy Treasurer Kaseta on November 25, 1992, which had put GSAM into the group of managers competing to run a large cap value portfolio. This schedule, as originally typed, indicated that both GSAM and CHMC were considered as candidates for a "core manager slot,"[31] consistent with the facts reported in a Boston Globe article dated June 28, 1992. Mr. Kaseta told the OIG in his interview on November 25, 1992, in response to this article, that he never seriously considered CHMC as a contender for a MASTERS contract, once he had learned that its superior performance results were primarily from its junk bond holdings.

The Department provided the OIG with a five-page summary on microfiche of the three-year and five-year performance results for the firms responding to the RFP, grouped by management style (e.g., "Large Capitalization Value").[32] This undated performance summary, which included the twelve existing domestic equity managers, put GSAM into a miscellaneous category called "Other."[33] That category contained four firms which apparently submitted proposals to manage a MASTERS portfolio in a style that did not fit into the system of classification established in the RFP. Callan's quarterly investment management performance report, prepared for the Department pursuant to the terms of its contract, show that the consultant continued to identify GSAM as a "core" manager.[34]

Finally, an internal memorandum dated May 21, 1993, from a staff member to the President of Callan, in response to the OIG's request for information from the Callan database states:

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[31]Bruce Mohl and Gerard O'Neill, "Malone Friends Benefit In Deals," Boston Globe, (June 28, 1992): 1, 8.

[32]Department, Untitled three-year and five-year performance summary for RFP respondents grouped by management style: "Small Capitalization - Value," "Large Capitalization - Value," Small Capitalization - Growth," "Large Capitalization - Growth," and "Other," (Microfiche), Files of the Department.

[33]Ibid.

[34]Callan, Investment Measurement Service, Massachusetts Teachers' and Employees' Retirement Systems, Executive Summary, (March 31, 1992): 23.

Pursuant to my conversations with Gordon Dickinson, we reran the graphs for MASTERS. According to Gordon, Masters did not look at a Value Product for Goldman Sachs, they looked at their quantitative strategy. Therefore, we removed Goldman from the Value managers grouping and ran the appropriate product against the Callan Total Database only.[35]

Thus, the preponderance of evidence shows that the Department treated GSAM as a special case, slotting the firm into a separate category in which it had no competition. Consistent with the argument that GSAM was treated differently, the OIG found that GSAM became a finalist late in the selection process. The OIG obtained a scoring booklet, dated June 1991, prepared by Callan, which the three members of the RFP selection committee appear to have used at the oral interviews with finalists. This booklet, which contains the names of ten money managers, does not include GSAM or Numeric, another firm that subsequently received a contract to manage a small cap growth portfolio.[36]

Furthermore, the OIG's staff found, in the files of the Commissioner of Banks, an undated, one page, performance report, entitled "Domestic Equity Management," produced by the Department, which compared the results of ten finalists relative to the benchmarks for each management style established in the RFP. This performance report also excluded both GSAM and Numeric.[37] The Deputy Treasurer provided the OIG's staff with a different version of this performance report, at the time of his interview on November 25, 1992, that included Numeric, but excluded GSAM.[38] He told the OIG that the second page which contained GSAM's results

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[35]Sheila Tansey, Callan. Memorandum to Ron Peyton, Callan, Subject: MASTERS graphs, c: Gordon Dickinson, May 21, 1993.

[36]Callan, Investment Manager Evaluation-Equity, Prepared for: Massachusetts Teachers' and Employees' Retirement System, (June 1991).

[37]Department, "Domestic Equity Management," Internal memorandum containing the performance results of ten investment management firms, (Undated), Files of the MSD.

[38]Department, "Domestic Equity Management," Internal memorandum containing the performance results of eleven investment management firms, (Undated), Files of the

was missing. On December 1, 1992, Deputy Treasurer Kaseta supplied the OIG with an amended version of this one page report which included results for GSAM in the category labeled "Large Capitalization Value."[39] (See Exhibit B on the following page.) Mr. Kaseta attributed the omission of GSAM on the earlier performance report to "clerical error." The OIG's review also found that the three-year and five-year returns, that were presented for GSAM in the report and which enabled this money manager to appear to outperform the other finalists in the large cap value category, were higher than the annualized figures in GSAM's proposal.

The one-page document entitled "Domestic Equity Management" presented to the OIG, on December 1, 1992, represented that GSAM had achieved "actual" results as a large cap value manager of 18.39 percent for three years and 16.41 percent for five years.[40] The results, as presented on that summary document to the OIG, gave the appearance GSAM had the best performance record of all finalists listed. These results, however, contradicted the lower results actually submitted by GSAM in its official proposal which yielded 16.62 percent for three years and 15.79 percent for five years.[41] If the results from GSAM's bid been listed on the Department's summary sheet, GSAM would not have finished as the top performer in the three-year and five-year category.

The Department appears to have placed GSAM in what was essentially a noncompetitive category. Although GSAM's performance results disqualified it from consideration as a large capitalization value manager, the selection process appears to have changed course in order to

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Department.

[39]Department, "Domestic Equity Management," as amended December 1, 1992. Internal memorandum containing the performance results of twelve investment management firms, (Undated), Files of the Department.

[40]Ibid.

[41]Goldman Sachs Asset Management (GSAM), RFP Response: Style: "Established Growth, Value Oriented, Small-Capitalization," (May 23, 1991): 37, Files of the Department. The OIG calculated GSAM's three-year and five-year returns from the data presented in its RFP response for its value product.

Exhibit B

DOMESTIC EQUITY MANAGEMENT

Investment Mangers invited to present equity management philosophy, style and mechanics.

The following Investment Managers were selected based on actual past performance (3-year and 5-year average annual returns), the trend of annual returns over a 10-year period and the breadth of research and analysis which support the investment decision process.

		Average Annual Returns 3 YR.	5 YR.
(A)	**LARGE CAPITALIZATION VALUE**		
(1)	Wertheim Schroder Investment Services	18.01%	16.10%
(2)	The Boston Company	16.43%	14.23%
(3)	Fleet/Norstar Investment Management	16.29%	14.07%
(4)	Fidelity Investment Management	13.80%	16.00%
* (5)	Goldman Sachs Asset Management	18.39%	16.41%
	Large Cap. Value Benchmark	*13.51%*	*12.76%*
(B)	**LARGE CAPITALIZATION GROWTH**		
(6)	Chancellor Investment Management	20.32%	19.73%
(7)	Fayez, Sarofin & Company	19.80%	16.80%
(8)	Putnam Management	19.39%	13.74%
(9)	Phoenix Investment Council	18.49%	16.95%
	Large Cap. Growth Benchmark	*14.24%*	*13.58%*
(C)	**SMALL CAPITALIZATION GROWTH**		
(10)	Fiduciary Trust Company	18.93%	30.99%
(11)	Fidelity Investment Management	22.38%	10.19%
(12)	Numeric Investors	18.92%	17.76%
	Small Cap. Growth Benchmark	*14.03%*	*10.19%*
	S & P 500	*17.26%*	*13.28%*

* Document Amended 12/1/92

Source: Office of the Treasurer

Note: This Exhibit from the Office of the Treasurer incorrectly states that Fidelity Investment Management had a 5 year average annual return for its "Aggressive Equity" product of 10.19%. The correct return in Fidelity's bid proposal dated May 23, 1991, for its "Aggressive Equity" product is 17.71%.

accommodate this particular firm. While the Department took certain outward steps to convey the appearance that GSAM was competing as a large cap value manager, documents obtained from the Department and from the consultant clearly show that it was being considered as a candidate for a separate category of "core" manager, a category that was not in the RFP. It seems likely that many other investment management firms might have qualified to compete for this slot if it had been advertised.

Finding 1b: The Department selected investment managers which did not meet the minimum requirements contained in the RFP for experience and performance.

The Department awarded contracts to one investment manager which misrepresented its assets under management to boost its performance results and to three investment managers which failed to meet the minimum standard for volume of assets under management. The RFP had stated that the "candidate must have at least $300 million in assets under management in the subject active equity product . . . and must have at least a five year performance history in the product(s) generated at the current firm or at a previous firm."[42] This type of criterion for the selection of money managers is frequently used by pension fund trustees. Its purpose is to ensure that the trustees select an organization which has the capacity, experience, and stability to manage large public pension funds. Yet the Department dispensed with this criterion and chose one firm which misrepresented its assets under management and three firms which did not have $300 million minimum under management in the discipline (e.g., large cap growth) for which they were being considered.

- **Chancellor received $160 million in plan assets to manage in a large cap growth portfolio despite its representation in its RFP response that it had only $155 million in assets under management in its proposed equity product.** Chancellor managed $6.1 billion in equity assets of which $5.3 billion was in large cap growth funds as of

[42]Department, RFP, (May 6, 1991): 5.

December 31, 1991.[43] However, Chancellor presented only $155 million, in response to the question in the RFP regarding total assets under management in the "subject active equity product."[44] What Chancellor appears to have done was to use its $5 billion in assets to demonstrate size, and its returns from "Select Growth," a smaller segment of its portfolio, to show performance.[45] According to a Callan document, "Select Growth" represents Chancellor's "top 40 stock selections" by "their 13 in-house research analysts."[46] The selection committee overlooked this sleight of hand, awarding Chancellor a contract to manage $160 million in plan assets in August 1991. The manner in which Chancellor submitted its performance results made it impossible to determine whether the firm met the standards in the RFP.

- **The Department's selection committee disregarded the minimum criterion for assets under management when it increased the allocation of pension funds to Greaves, an existing money manager, from approximately $11 million to $50.4 million.** Greaves reported $180.8 million under management, all in a large capitalization value-oriented style, as of December 31, 1990, or about 60 percent of the $300 million minimum criterion in the RFP.[47] In a cover letter accompanying its proposal, Greaves stated that the firm did not have $300 million in assets under management, but noted that its funds

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[43]Chancellor, RFP Response: Style: "Large Capitalization Growth," (May 23, 1991): 5, Files of the Department.

[44]Chancellor, RFP Response, (May 23, 1991): 5, B. Assets Under Management, 1 (d) Total assets managed in the subject active equity product, Files of the Department.

[45]Chancellor, RFP Response, (May 23, 1991): 18.

[46]Callan, Investment Manager Evaluation-Equity, (May 1991): 26.

[47]Greaves Capital Management, Inc. (Greaves), RFP Response: Style: "Value Oriented," (May 23, 1991): B. Assets Under Management, Table 1, 1 (a) Total assets under management and 1 (d) Total assets managed in the subject active equity product, Files of the Department.

had grown to $230 million with an expectation of adding $10 million.[48] Greaves' cover letter also reminded the Deputy Treasurer that the firm did not have five full calendar years of performance numbers.[49] The selection committee retained Greaves, as well as increasing the size of its MASTERS' portfolio in August 1991.

- **The Department ignored Numeric's shortfall in assets under management and lack of experience in managing small cap growth funds when it chose this firm to manage $25 million in pension funds.** Numeric's President stated in the cover letter accompanying its proposal, dated June 12, 1990, nineteen days after the final filing date in the RFP, that the firm did not meet the Department's criteria for assets under management. He wrote:

> We understand that you must consider our firm somewhat outside of the manager search process currently underway. We are submitting our answers to the questionnaire and our fee proposal at your suggestion, **but you and we both know that our firm is too new and small to meet some of the criteria specified in the RFP.** Nonetheless you have graciously agreed to consider hiring Numeric to manage an equity portfolio for the Commonwealth given our superb investment performance record and the specialized nature of our investment process."[50] [Emphasis added.]

This letter added:

[48]Keith A. Greaves, CFA, President, Greaves. Letter to Steven Kaseta, May 21, 1991, Files of the Department.

[49]Ibid.

[50]Langdon B. Wheeler, CFA, President, Numeric. Letter to Steven J. Kaseta, June 12, 1991: 1, Files of Numeric .

> We do not have $300 million under management in the active equity management products that we are proposing to manage for MASTERS. . . [51]

Furthermore, the letter noted:

> We have a five year performance history only by linking our investment results while we were employed at State Street with our investment results since founding Numeric in the fall of 1989.[52]

The Department only provided the OIG with part of this letter, the last three pages, attached to a copy of the firm's proposal of June 12th, despite a specific document request on March 26, 1993, for its correspondence with Numeric. These pages did not contain the statement, quoted above, in regard to Numeric's failure to meet the RFP criteria.

Numeric's proposal indicated that the firm had total assets under management of $140 million as of December 30, 1990.[53] The firm reported total assets in its "Core Aggressive Strategy" of $48 million; total assets in its "Quantitative Growth Strategy" of $7 million; and no assets under management in its "Quantitative Small Cap" strategy as of December 31, 1990.[54] The selection committee selected Numeric to make a presentation June 20, 1991, for "Small Cap Growth." At this time Numeric had managed only one small cap growth account, valued at $5.6 million, for the Collins Group Trust I, of Costa Mesa,

[51]Wheeler. Letter to Kaseta, June 12, 1991: 3, Files of Numeric.

[52]Ibid.

[53]Numeric, <u>Answers to Questionnaire In Response To Masters Trust Active Equity Investment Management Request for Proposal</u>, RFP Response: Style: "Core/Growth/Small Cap," (June 12, 1991): 6, Files of Numeric.

[54]Ibid.

California, which they had managed for only forty-two days, since May 1, 1991.[55] Despite this shortcoming, the selection committee eventually awarded Numeric a contract to manage $25 million in MASTERS "Small Cap Growth" funds. Including the principals' previous investment history together, they had never managed more than $125 million in any discipline.[56]

- **The Department overlooked GSAM's failure to meet the requirement for assets under management and five-year performance history.** GSAM submitted one consolidated proposal to manage three separate portfolios, as mentioned above. This tactic enabled GSAM to combine its assets under management into a lump sum in its RFP response. GSAM, however, reported a total of only $848 million in assets under management in its "proposed equity product".[57] Thus, this relatively new division of Goldman Sachs & Co., GSAM, did not by definition, meet the minimum criterion in the RFP of having $300 million in assets in each of the three products that it was seeking to manage for the MASTERS Trust.

  In addition, GSAM failed to meet the RFP requirement of a 5 year history of managing the subject active equity product. GSAM stated in its proposal, "Client money has been under management using the active equity approach since 1989."[58]

The Department dispensed with the required five-year investment team track record for two of the firms selected. The RFP stated that the "key investment professionals must have

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[55]Numeric, Answers to Questionnaire, (June 12, 1991): 7, Files of Numeric. Numeric, Introduction to Numeric Investors And Its Quantitative Small Cap Investment Strategy, A presentation To The MASTERS Trust, (June 20, 1991): 20, Files of Numeric.

[56]Numeric, Answers to Questionnaire, (June 12, 1991): 6, Files of Numeric.

[57]GSAM, RFP Response, (May 23, 1991): 7, "Assets Under Management," Files of the Department.

[58]GSAM, RFP Response, (May 23, 1991): 37.

worked together at least five years at either their current or former employer."[59] This organizational requirement recognizes the fiduciary status of the investment management firm. It is designed to exclude pension funds from falling into the hands of firms with a high turnover among key investment professionals, or of firms who put together a team expressly for the purpose of garnering a particular contract. The selection committee bent this criterion for Numeric and GSAM. Both of these firms had informed the Office of the Treasurer that they did not meet the five-year requirement.

Numeric, which only began operations in 1989, stated in its proposal cover letter that it did not meet the five-year history requirement. Numeric's letter of June 12, 1991, explained:

> The three key investment professionals have not worked together for five years. John Bogle and Lang Wheeler have worked together for almost four years, since October 1987 when John joined Lang in the Asset Management Division at State Street Bank. Jim Sloman and Lang Wheeler have worked together since Numeric's founding in the fall of 1989. John joined Numeric from State Street ten months ago.[60]

Not only did the Department award Numeric a contract but they also paid Numeric more in fees than the firm had officially proposed in its RFP response. Numeric stated in the letter accompanying its proposal that its proposed fee was "60 basis points for amounts up to $100 million and 50 basis points for any amount over $100 million."[61] On the $25,000,000 eventually awarded to Numeric, this represented a proposed fee of $150,000 per year.

The Department awarded a contract to Numeric on the following basis: .75 percent of the first $20 million; .60 percent of the next $30 million; .50 percent of the next $50 million; and

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[59]Department, RFP, (May 6, 1991): 5.

[60]Wheeler. Letter to Kaseta, June 12, 1992: 3, Files of Numeric.

[61]Wheeler. Letter to Kaseta, June 12, 1991: 5, "Fee Proposal," Files of Numeric.

.40 percent of any amount over $100 million.[62] On the $25 million awarded to Numeric, this represents an awarded fee of $180,000 per year. This increase in fees cost the beneficiaries of the MASTERS Trust $30,000 more than the amount contained in Numeric's final proposal.

The proposal submitted by GSAM also pointed out that the firm failed to meet the five-year track record. GSAM's May 23 1991, proposal attachment stated:

> Prospective Manager warrants that it meets all of the minimum criteria set forth on pages 5-6 of the RFP except as discussed with Mark Baker on May 16, 1991 including the lack of the 5 year requirements.[63]

In response to the RFP requirement that key investment professionals have a five year history of working together, GSAM identified one individual, under "Key Equity personnel," as the proposed portfolio manager for the account. This person had been with the firm four years. Of the eight other equity personnel listed by GSAM as "Key Equity Personnel" on the MASTERS Trust fund account, whose biographies followed, only one, an Assistant Portfolio Manager, had been with the firm five years or longer. None of these individuals had previously been together at any other money management firm.[64]

In addition, GSAM failed to meet the RFP requirement of a five-year history of managing the subject active equity product. GSAM stated in its proposal, "Client money has been under management using the active equity approach since 1989."[65]

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[62]Treasurer of the Commonwealth of Massachusetts as Trustee of the Massachusetts State Teachers' and Employees' Retirement Systems Trust and Numeric, Investment Management Agreement as of July 31, 1991, (July 31, 1991): Exhibit C, "Schedule of Advisory Fees," Files of the Department.

[63]GSAM, RFP Response, (May 23, 1991): Attachment III Warranties (e), Files of the Department.

[64]GSAM, RFP Response, (May 23, 1991): 14-18.

[65]GSAM, RFP Response, (May 23, 1991): 37.

The Department selected three money managers that failed to qualify for this competition because of their investment performance. The RFP stated "[t]o qualify for consideration in this search process, the candidate MUST meet the following performance criteria: (a) Have achieved a rate of return greater than the returns provided in Table 1 below for BOTH the 3 years and 5 years annualized returns ending 12/31/90 AND (b) Have achieved a rate of return greater than 3 of the 5 annual periods ending 12/31/90 provided in Table 2 below."[66]

The RFP had two separate threshold tests. First, to qualify for consideration, the RFP stated that the candidate had to achieve a rate of return for three and five years annualized for the period ending December 31, 1990, that exceeded the benchmarks established for the management discipline(s) for which it was submitting a proposal: Large Cap Growth, Large Cap Value, Small Cap Growth, and Small Cap Value. Second, the RFP stated that candidates must exceed an established target for three of the five annual periods (i.e., four quarters) ending December 31, 1990. (See Tables 1 and 2 on the following page.)

The selection committee dispensed with these performance criteria for three existing money managers.

- **The Department retained MFS, which had served as a medium to large cap growth manager for MASTERS since 1987 even though MFS failed to meet the five-year benchmark established in the RFP and only passed the target returns in the RFP for one out of five annual periods.**[67] The Department assigned MFS average three-year returns of 20.15 percent and average five-year returns of 12.82 percent for the category

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[66]Department, RFP, (May 6, 1991): 5.

[67]Massachusetts Financial Services Company (MFS), RFP Response: Style: "Growth Equity Management," (May 23, 1991): 24, Files of the Department. The OIG calculated MFS's three-year and five-year returns and returns for the five annual periods ending December 30, 1990, from data presented in its RFP.

Table 1

	3 years ending 12/31/90	5 years ending 12/31/90
Large Cap Growth	14.24%	13.58%
Large Cap Value	13.51%	12.76%
Small Cap Growth	14.03%	10.19%
Small Cap Value	10.95%	9.53%

Source: Office of the Treasurer, Request for Proposal (RFP) May 6, 1991

Table 2

	--------------4 Quarters Ending----------------				
	12/31/90	12/31/89	12/31/88	12/31/87	12/31/86
Large Cap Growth	0.94%	34.65%	14.94%	8.59%	19.06%
Large Cap Value	(1.11%)	27.06%	20.32%	5.92%	19.11%
Small Cap Growth	(5.91%)	32.76%	20.04%	0.86%	13.16%
Small Cap Value	(10.73%)	20.10%	31.88%	2.85%	19.06%

Source: Office of the Treasurer, Request for Proposal (RFP) May 6, 1991 called "Large Capitalization - Growth," significantly exaggerating the three-year results in MFS's proposal, and boosting its performance compared to other managers.[68] MFS's results in Callan's February 1991 report on existing managers which reflected its performance for MASTERS were worse, showing that MFS missed both the three-year and five-year bench mark in the RFP as well as the target returns for all five annual periods.[69] Callan stated:

> Performance for recent periods, calendar years and stock market cycles manifest below average performance relative to the S&P 500 index. Cumulative performance for the last five years has been on a downward trend. Relative to the growth equity style group, Massachusetts Financial Services ranked consistently in the 80th and 90th deciles.[70]

Despite this report by Callan, the Department rewarded MFS with a bigger contract, increasing its investment of State pension funds from $85 million to $160 million. Other competitors for the large cap growth manager contract submitted performance results which not only met the minimum standards of the competition, but greatly exceeded them. One example is IDS, which had been ranked by Callan among the top 1 percent of investment managers nationwide over the previous five-year period.[71]

- **The Department retained Equitable, an existing large cap growth manager, even though Equitable's investment performance as reported in its proposal and in Callan's February 1991 report missed both the five-year benchmark in the RFP and**

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[68]Department, Untitled three year and five year performance summary by management style: "Large Capitalization - Growth," Files of the Department.

[69]Callan, Preliminary Equity Management Structure Analysis, Prepared for Massachusetts Teachers and Employees Retirement System, (February, 1991): 80.

[70]Callan, Preliminary Equity Management Structure Analysis, (February 1991): 79.

[71]Callan, Preliminary Equity Management Structure Analysis, (February 1991): 35.

also the "established bogey" in the RFP for three of the last five annual periods.[72] The Department increased the amount of plan assets that Equitable managed from $69 million to approximately $160 million.

- **The Department increased Morgan Stanley's share of plan assets from $62 million to $100 million despite the firm's failure to meet the three-year benchmark for investment performance.** Morgan Stanley's results for its small cap product, as presented in its proposal, as well as in Callan's February 1991 report, show that this firm failed to meet the three year benchmark in the RFP.[73] It is significant that the Department increased the asset allocation to a firm which failed to meet one of the minimum performance requirements while other firms which exceeded the RFP requirements by a considerable amount were bypassed. For example, Fiduciary Trust Company International (Fiduciary), an unsuccessful contender to manage a small cap portfolio, had three-year performance results of 18.93 percent and five-year results of 30.99 percent, as shown in Exhibit B, compared to Morgan Stanley's results of 12.60 percent and 12.50 percent.[74] The Department overlooked Fiduciary's superior performance, increasing the amount Morgan Stanley managed from $62 million to $100 million.

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[72] Equitable Capital Management Corporation (Equitable), RFP Response: Style: "Growth - - Current Style Managed for MASTERS," (May 24, 1991): 13, Files of the Department. The OIG calculated Equitable's three-year and five-year returns and returns for the five annual periods ending December 30, 1990, from data presented in its RFP. Department, <u>RFP</u>, (May 6, 1991): 6.

[73] Morgan Stanley Asset Management (Morgan Stanley), RFP Response: Style: "Emerging Growth Equities," (May 23, 1991): "Quarterly Rates of Return for Emerging Growth Composite," Files of the Department. Callan, <u>Preliminary Equity Management Structure Analysis</u>, (February 1991): 89.

[74] Morgan Stanley, RFP Response, (May 23, 1991): "Quarterly Rates of Return for Emerging Growth Composite," Files of the Department. The OIG calculated Morgan Stanley's three-year and five-year returns from data presented in its RFP response.

The Department violated its own rule that investment managers be selected based on actual past performance when it chose two firms using simulated or "what if" data to document performance. The Department clearly established that firms were evaluated on the basis of actual performance results. A document, entitled "Domestic Equity Management," produced by the Department states:

> The following investment Managers were selected based on **actual past performance** (3-year and 5-year average annual returns), the trend of annual returns over a 10-year period and the breadth of research and analysis which support the investment decision process."[75] [Emphasis added.]

This document lists the twelve finalists scheduled for oral interviews by style, comparing their three-year and five-year returns to the benchmark established in the RFP. The OIG's review of proposals submitted in response to the RFP revealed, however, that two of the money managers which received MASTERS contracts had used simulated or "what if" data in order to exceed the established benchmark.

- **GSAM used simulated data in order to exceed the established benchmark for performance.** GSAM's results, as reported by the Department in Exhibit B, appear to show that it had achieved an average rate of return on its large cap value equity product of 18.39 percent in relation to the three-year benchmark, and 16.41 percent in relation to the five-year benchmark, enabling it to surpass four other finalists in the large cap value category, albeit barely beating its closest competitor, Wertheim Schroder Investment Services, Inc. (Wertheim). Another version of that performance summary that was found in the Department's files, listing GSAM with so called "Other" firms, contains those same numerical results penned over a typewritten "N/A"[76] Exhibit B states that the results

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[75]Department, "Domestic Equity Management" as amended 12/1/92, Files of the Department.

[76]Department, Untitled three-year and five-year performance summary by management style: "Other," Files of the Department.

given were the actual performance results. However, GSAM's proposal to MASTERS said:

> Client money has been under management using the active equity approach since 1989. From 1986-1988, we maintained documented paper portfolios to generate real-time results. Our performance for clients since 1989 has been entirely consistent with both our real-time results and simulated results.[77]

A Callan report, dated May 1991, on those twelve candidates for domestic equity manager that did not currently hold contracts with the MASTERS Trust, and which the Department considered finalists, confirms that GSAM did not begin to manage equity accounts until 1989.[78] This document omits any performance data for GSAM prior to 1990.[79]

- **Numeric relied on an imaginary investment history to compete with the performance of other investment managers.** The Department assigned an average three-year rate of return of 18.92 percent and a five-year rate of return of 17.76 percent to Numeric in the small cap growth category in the document entitled "Domestic Equity Management" shown in Exhibit B. This firm, only in business since 1989, submitted performance results as part of its RFP which appeared to match those of Fiduciary and Fidelity Management Trust Company (Fidelity). Numeric's returns were not based on actual results, however, despite the claim at the top of Exhibit B which had stated:

> The following investment managers were selected based upon past performance (3-year and 5-year average annual returns). . . .

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[77]GSAM, RFP Response, (May 23, 1991): 37, Files of the Department.

[78]Callan, Investment Manager Evaluation-Equity, (May 1991): 56-57.

[79]Callan, Investment Manager Evaluation-Equity, (May 1991): 61-62.

According to its proposal, Numeric had only managed a single small cap growth fund, one with a market value of $5,490,753.47, and only since May 1, 1991.[80] The minimum RFP requirement was $300 million. Numeric did not claim to have any experience in managing small cap growth funds other than this single $5,490,753.47 fund. Nevertheless, Numeric claimed a "10 Year" cumulative return of 551.2 percent, at its oral presentation on June 20, 1991, relying on a "simulated" or an imaginary investment history.[81]

The same May 1991 Callan report mentioned above documented just two quarters of Numeric's actual performance in comparison to the five year results reported for other firms which had proposed to manage a small cap growth portfolio.[82] These Numeric results were erroneously reported by Callan, however, since Numeric had not managed any such small cap growth funds during that period of time. Instead of reporting that Numeric had no experience in managing small cap growth funds during the time period relevant to the RFP, Callan listed performance results from a different Numeric fund, one which was not a small cap growth fund, and represented these results to be Numeric's small cap growth performance results.[83] Callan listed performance results which Numeric

[80]Numeric, Sample Portfolios for the Numeric Investors' Core Aggressive, Quantitative Growth, and Quantitative Small Cap Strategies, (June 12, 1991): 000111. (Punctuation ours.) Numeric, Answers to Questionnaire, (June 12, 1991): 7.

[81]Numeric, Introduction to Numeric Investors And Its Quantitative Small Cap Investment Strategy, (June 20, 1991): 000129, Files of Numeric.

[82]Callan, Investment Manager Evaluation-Equity, (May 1991): 46.

[83]Telefax to Melissa Davis, Callan, September 27, 1991, enclosing Numeric's responses to Callan, Investment Manager Questionnaire 1991, (Undated): (000369), (000354)), Files of Numeric. The small cap growth results reported for Numeric by Callan in the report dated May 1991 (39.30 percent for the most recent quarter, 67.30 percent for the two most recent quarters) were derived from Numeric's response to Callan's Investment Manager Questionnaire 1991, submitted on September 27, 1991, for its quantitative growth fund. Numeric's RFP response lists only one quantitative growth fund under management during this time period (i.e., $3.5 million managed since September 13, 1990, for the "Social Security Administration of a Foreign Government."). In its September 27, 1991, response to

claimed to have achieved while managing a $3.5 million dollar "quantitative growth" fund for an unnamed foreign government.[84] The Callan document provided no cumulative performance data for Numeric, as it did for the other firms, for the last five years despite the fact that five years was a minimum RFP requirement. Referring to a five-year analysis of Numeric's "risk/reward structure" for its small cap growth portfolio, this report states, "There is insufficient data for Numeric during this time period."[85]

Finding 2: The Department apparently failed to inform the Banking Commissioner that investment managers for the MASTER's Trust were selected without regard for the rules and standards set forth in the RFP.

The Deputy Treasurer told the PIC at its meeting on April 23, 1991, that the Treasurer would issue an RFP for domestic equity managers. The Department provided this RFP, issued May 6, 1991, to the Commissioner of Banks, a PIC member. The PIC had the statutory responsibility to approve the selection of investment managers. The "Introduction" to this RFP stated:

> The purpose of this request for proposal is to select a capable firm to provide investment management services in an open, fair, competitive process designed to meet the needs of, and best serve, the Commonwealth.[86]

Former Commissioner of Banks Michael Hanson served on the PIC from April 1, 1991, through July 13, 1992. The minutes of the PIC meetings showed that Mr. Hanson actively sought

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Callan's Investment Manager Questionnaire, Numeric lists no "live money" performance results for its small cap growth fund until May 1, 1991, instead listing "simulated results" through December 31, 1990. Thus, Callan reported the results from Numeric's "live money" quantitative growth fund in its report dated May 1991.

[84]Numeric, Answers to Questionnaire, (June 12, 1991): 7.

[85]Callan, Investment Manager Evaluation-Equity, (May 1991): 49.

[86]Department, RFP, (May 6, 1991): 1.

information from the Deputy Treasurer, who chaired the PIC meetings at each session that he attended. However, according to Mr. Hanson, who spoke under oath to the OIG on April 12, 1993, the Deputy Treasurer never informed him that the Department was not following the procedural rules and standards set out in the RFP. Mr. Hanson stated that Deputy Treasurer Kaseta told him that the selection of managers was conducted by the competitive RFP process, that the RFP process was done appropriately, and that every manager that had been selected met the RFP requirements.[87] Based on this information, Mr. Hanson expressed his approval, on behalf of PIC, of the Treasurer's selection of ten money managers at its meeting on August 22, 1991.[88]

The minutes of the PIC meetings prior to August 22, 1991, show that both Callan's Senior Vice President Gordon Dickinson and Deputy Treasurer Kaseta suggested that performance criteria, such as those stipulated in an RFP, would be a key factor in the selection of money managers. The minutes of the PIC meeting of June 19, 1991 state:

> Gordon Dickinson, representing Callan Associates, the consulting firm for the MASTERS Trust, reviewed the domestic equity search. The objective is to upgrade and consolidate the managers thus improving the overall quality of the asset category and ultimately the fund. The purpose is not to fire all the current managers but rather to see what all firms have to offer. Mr. Dickinson recognized that changing managers is an expensive process but necessary at the present time.[89]

Mr. Kaseta assured the PIC at this meeting that the Department was placing an emphasis on the candidates' performance history:

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[87]Hanson. Interview: 10, 39, 23.

[88]PIC meeting, (August 22, 1991): 4.

[89]PIC Meeting, (June 19, 1991): 1.

Mr. Kaseta explained that the potential managers are being reviewed on a longer term performance basis. Data of their past three and five year performance history will be a **critical** issue in the hiring process."[90] [Emphasis added.]

While Mr. Dickinson and Mr. Kaseta gave the appearance of conducting a competitive search process for qualified firms, in accordance with the established RFP process, they had in fact disregarded the rules and standards of the competition. In addition, the Department does not appear to have provided documents to Mr. Hanson which would have enabled him to make an informed judgement about the qualifications of the competing firms. Such documents included a five page package produced by the Department, listing the total assets that each respondent to the RFP had under management, and their three-year and five-year returns relative to the benchmarks in the RFP; and a 64-page Callan analysis, dated May 1991, of the investment history of the twelve finalists that participated in oral interviews.[91] The five-page package with three-year and five-year investment returns showed that some firms missed the benchmarks in the RFP.

The only significant documents pertaining to the domestic equity search provided by the Department that were found in the former Banking Commissioner's files were the RFP and an early version of the Department's performance summary entitled "Domestic Equity Management" which included the three-year and five-year returns of ten of the twelve *new* firms that were finalists, **excluding** GSAM and Numeric. None of these ten firms were existing managers. No other information was found in Mr. Hanson's files comparing the performance results of candidate firms, including existing managers, or indicating that any finalists had failed to meet the RFP requirements.

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[90]PIC Meeting, (June 19, 1991): 2.

[91]Department, Untitled three-year and five-year performance summary by management style, Files of the Department. Callan, Investment Manager Evaluation-Equity, (May 1991).

Mr. Hanson told the OIG that he did not know that several firms had not met the qualifications stipulated in the RFP. For example, Mr. Hanson said that he did not know that Greaves and Numeric had not had $300 million in assets under management in the equity product that they were seeking to manage.[92] Mr. Hanson also told the OIG that he did not know that three existing managers whose contracts were not merely renewed but expanded, MFS, Equitable, and Morgan Stanley, did not meet all of the performance criteria established in the RFP.[93] He also stated in his interview that Department employees did not inform him that two managers, Numeric and GSAM, achieved returns which allowed them to qualify for consideration only by using so called simulated or imaginary data.[94]

Mr. Hanson stated in an interview with the OIG that he first learned of the Department's manager changes from an announcement in the Boston Globe on August 3, 1991.[95] He said that he was "taken by surprise" and responded by calling the Treasurer to tell him that "the PIC should have been informed before we read it in the Globe."[96] According to Mr. Hanson, the Treasurer agreed and had Mr. Kaseta call Mr. Hanson that afternoon to discuss the process in greater detail than at the meeting.[97] Based upon this and subsequent telephone conversations with the Treasurer and Deputy Treasurer, he said, referring to the PIC, that "we were adequately informed."[98] Evidently Mr. Hanson was not informed at that time, or at any later time, that certain firms were selected in violation of the RFP process. Mr. Hanson expressed support on behalf of the PIC for the selection process at the August 22, 1991, PIC meeting. Referring to

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[92]Hanson. Interview: 19-21.

[93]Hanson. Interview: 14-15; 17; 18-19.

[94]Hanson. Interview: 26-27.

[95]Hanson. Interview: 38.

[96]Ibid.

[97]Hanson. Interview: 39.

[98]Ibid.

his approval of these contracts, Mr. Hanson stated: "We did rely upon the statements that were made by the staff and the Treasurer as to the procedure."[99]

When asked in his interview if he was aware of the fiduciary standard in the law that PIC members had to meet, Mr. Hanson stated that he was "very aware of the statute."[100] He said, "I tried to conduct my activities in accordance with that."[101]

However, in the context of his other duties, Mr. Hanson said that he had viewed his role on the PIC as if he were a member of a corporate board of directors, and had relied on the employees of the Department to manage the MASTERS Trust on a daily basis.[102] Referring to the selection of professional money managers, he stated:

> I think that in the operation of the Masters Trust. . . the PIC has to rely on the day to day decision making of the Treasurer and we respected this particular issue.[103]

Finding 3: On two separate occasions, the Department and its consultant, Callan, backdated documents created after the award of the contracts, in an apparent attempt to justify the managers that were selected.

Callan and the Department created two series of backdated documents which gave the appearance that the competition had been conducted properly.

- In the fall of 1991, Callan Senior Vice President Gordon Dickinson backdated evaluation reports of the twelve *new* firms which were finalists for domestic equity manager, at the

[99]Hanson. Interview: 41.

[100]Hanson. Interview: 36.

[101]Ibid.

[102]Hanson. Interview: 36.

[103]Hanson. Interview: 40-41.

request of the Department. Dickinson attached backdated and signed cover letters to these reports to reinforce the impression that they had been created contemporaneously with the competition.

- The Department and Callan undertook a second round of backdating a year later following a press report which criticized the 1991 domestic equity manager selection process as yielding a "phony competition."[104] Lawyers for the Department admitted, upon questioning by the OIG, that a report dated May 1991 and marked "Copyright 1991" had actually been created in the summer of 1992, more than a year after the competition had been concluded. Two Deputy Treasurers told staff of the OIG in November 1992 that the report had been used by the Department during the selection process.

The attorneys for the Department provided the OIG with the letters, mentioned above, from Gordon Dickinson, Senior Vice President of Callan, to Deputy Treasurer Kaseta, at a meeting on February 8, 1992. These letters, which were dated June 10, 1991; June 30, 1991; and September 30, 1991, appeared to be evaluations of the qualifications of the twelve finalists for domestic equity manager, created during the manager search process, pursuant to the terms of Callan's contract with the Department.[105] This contract stated that "[a] due diligence committee of senior Callan consultants" would choose a group of candidates from a preliminary list drawn

[104] Mohl and O'Neill, "Malone Friends Benefit In Deals," Boston Globe, (June 28, 1992): 8.

[105] Gordon E. Dickinson, Senior Vice President, Callan. Letters to Mr. Steve Kaseta concerning Callan's evaluation of Chancellor; The Boston Company Institutional Investors Inc. (The Boston Co.); GSAM; Fidelity Management Trust Company (Fidelity); and Numeric (June 10, 1991); Callan's evaluation of Wertheim Schroder Investment Services, Inc. (Wertheim); Fidelity; Fleet/Norstar Investment Advisors; Fayez Sarofim & Co, The Putnam Companies; Provident Investment Counsel; and Fiduciary Trust Company International (June 30, 1991); and Callan's evaluation of Chancellor, The Boston Co., GSAM, Fidelity, and Numeric (September 30, 1991).

from Callan's database prior to any search and later prepare a search report comparing candidates that would include "a brief summary of the strengths of each of the finalists."[106]

Those letters were the product of an urgent initiative by the Department, following the awarding of the contracts, to create a documented record of a process which never took place, in which Callan supposedly provided detailed comparative analyses of the candidate firms to the Department. The urgency with which these reports were created is demonstrated by the correspondence between Callan and one of the managers, Numeric, after Numeric had been hired as a small cap manager. The letter from Callan to Numeric (shown in Exhibit C on the following page) states:

> As you know, Callan has been directed by Mr. Steve Kaseta and Staff at MASTERS to prepare a profile of your firm. Apparently we only have cursory information, and in any event we do not have any small cap performance figures . . . .
>
> Thank you for your patience and for understanding the **urgency** of this matter.[107] [Emphasis added.]

Backdated evaluation reports, created and originally dated after the awarding of contracts and later redone to carry a date prior to the awarding of contracts, conveyed the impression that Callan had methodically analyzed the qualifications and performance history of the candidate firms during the selection process and presented their analysis to the Department. As this correspondence clearly indicates, no such analysis was ever provided to the Department by Callan prior to awarding of the contracts, since Callan had no information about the small cap performance of Numeric until after Numeric received a $25 million small cap contract.

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[106]Callan and MASTERS Trust, Agreement, (July 31, 1990): 3.

[107]John Lopez, Assistant Vice President, Callan. Letter to Mr. Lang Wheeler, Numeric, September 23, 1991. Files of Numeric.

Exhibit C

CAI CALLAN ASSOCIATES INC.
San Francisco, New York, Chicago, Atlanta

September 23, 1991

Mr. Lang Wheeler
Numeric Investors
One Memorial Drive
Cambridge, MA 02142

Dear Mr. Wheeler:

As you know, Callan has been directed by Mr. Steve Kaseta and Staff at MASTERS to prepare a profile of your firm. Apparently we only have cursory information, and in any event we do not have any of the small cap performance figures. Enclosed please find a copy of the Callan Associates Survey. At your earliest opportunity please complete the information and return it to us is San Francisco, but no latter than this Thursday September 26, 1991.

Thank you for your patience and for understanding the urgency of this matter. Should you have any questions, please call either myself or Margaret Latartara in our manager search group here in San Francisco at (415) 974-5060.

Best regards,

John Lopez
Assistant Vice President

Source: Numeric Investors, l.p., Cambridge, MA.

71 Stevenson Street, Suite 1300, San Francisco, CA 94105 • 415 / 974-5060

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After criticism about the selection process emerged, the Department asked Callan to create written evaluations of the candidate firms. Callan's records indicate that the consultant complied with this request on September 30, 1991, by providing evaluations of the winning firms correctly dating these evaluations September 30, 1991. According to Mr. Dickinson, after these reports were transmitted to Mr. Kaseta, the Department requested that the letters be done over.[108] The revised reports were dated June 10, 1991, prior to the award of the contracts. Callan attached a signed cover letter from Mr. Dickinson, carrying a date of June 10, 1991, to each report. Thus, the reports gave the false appearance of having been created and used during the selection process.

The letters dated June 10, 1991, and September 30, 1991, evaluated the five new firms which had received contract awards to invest MASTERS funds: Chancellor, The Boston Company Institutional Investors, Inc. (The Boston Co.), GSAM, Fidelity, and Numeric. The June 10, 1991, and September 30, 1991, letters were identical except that the letter dated September 30, 1991, carried performance data through June 30, 1991, for four of the firms. Numeric's data was alike with only the dates on Dickinson's transmittal letter and the report cover changed. Both letters carried performance data for Numeric only through December 30, 1990.[109]

The Department's attorneys said that the Department asked Callan to redo the letters dated September 30, 1991, because they carried performance data through June 30, 1991, that would not have been available to the selection committee at the time of the competition.[110] This explanation, which was not true in all cases, does not explain the fact that the reports themselves were backdated and attached to backdated cover letters. Callan dated their original reports

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[108]Dickinson. Interview: 122-123.

[109]Gordon E. Dickinson, Callan. Letter to Mr. Steve Kaseta concerning Callan's evaluation of Numeric, June 10, 1991: 4. Gordon E. Dickinson, Callan. Letter to Mr. Steve Kaseta concerning Callan's evaluation of Numeric, September 30, 1991: 4.

[110]Robert Weinberg, Esq., and Ian Lanoff, Esq., Bredhoff and Kaiser, Washington, D.C. Interview with the OIG, February 8, 1993.

September 30, 1991, the date on which they were created, even though the reports carried performance figures only through June 30, 1991, three months earlier. Therefore, it would be wholly inconsistent and contradictory for Callan to backdate the subsequent reports and cover letters themselves if it simply wished to report different performance periods. Thus, the backdating of the reports and cover letters represents a serious and disturbing act by Callan and the Department.

The Callan letters dated June 30, 1991, evaluated the seven firms which participated in oral interviews but did not receive MASTERS contracts: Wertheim, Fidelity, Fleet/Norstar Investment Advisors, Fayez Sarofim & Co., The Putnam Companies, Provident Investment Counsel, and Fiduciary.[111] Fidelity had received a contract for its large cap value product.

Callan's original letters dated September 30, 1991, closely following the date of the Department's original request, would have represented a legitimate analysis of the winning firms. Apparently, these letters did not serve the Department's purpose of conveying the impression that Callan had reviewed the firms' qualifications during the search. Thus, the Department asked Callan to re-do the letters so that they would only contain information through the first quarter of 1991, and to backdate these documents to June 1991.

Callan's letter dated June 10, 1991 evaluating Numeric gave the impression that this firm was a bona fide contender. In fact, Numeric did not file its proposal in response to the Department's RFP until June 13, 1991, **three days after the date on Callan's letter** endorsing the firm's qualifications to serve as a small cap manager. Numeric only provided Callan on September 27, 1991, the "simulated" or imaginary returns for the period January 1, 1982 through December 31, 1990, for its quantitative small cap portfolio, which appeared in the letter dated

[111] Gordon E. Dickinson. Letters to Mr. Steve Kaseta, June 10, 1991.

June 10, 1991.[112] Numeric forwarded these hypothetical investment returns in response to Callan's letter of September 23, 1991 (shown in Exhibit C) conveying the urgent nature of the Department's request. Since Numeric's data did not change, no purpose was served by backdating the letter other than creating the false impression that Callan had produced this analysis during the search process.

The OIG's staff asked Gordon Dickinson in his interview under oath on February 25, 1993, if he discussed the Department's request with anyone in his firm before producing backdated documents. Dickinson stated that he did discuss the Department's request to backdate the letters with his colleagues. He said that he could not "remember exactly" which person.[113] Dickinson said, "Probably Jim O'Leary."[114] O'Leary is a Callan vice president who formerly serviced the MASTERS account.

Dickinson added: "I think the discussion would have centered on, "Why do they want us to do this?"[115] Dickinson indicated that he thought that the Department's intent was to "formalize an informal process."[116]

When asked by the Department's staff if he thought that the documents dated June 1991, might give the false impression that they were produced at an earlier time, Dickinson replied, "Well, in this context it can clearly appear that way."[117]

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[112]Lang Wheeler, Numeric. Telefax to Melissa Davis, Callan, September 27, 1991, enclosing Numeric's responses to Callan, Investment Manager Questionnaire 1991, (Undated): 000369, Files of Numeric.

[113]Dickinson, Interview: 125.

[114]Ibid.

[115]Ibid.

[116]Dickinson. Interview: 124.

[117]Dickinson. Interview: 126.

When asked the reasons for signing such a misleading document, Dickinson told the OIG that the firm was not thinking about things from a legal point of view. Mr. Dickinson said, "We consider our role to be supporting our clients, not to be independent fiduciaries."[118]

Although they were not distributed, these letters, which appeared to be a contemporaneous analysis of the qualifications of those firms competing to serve as domestic equity managers, were placed in the files of the PID. According to the Department's attorneys, these documents were never presented to anyone outside of the Department prior to providing them to the OIG pursuant to this investigation. One of the Department's attorneys told the OIG's staff in the meeting on February 8, 1993, that someone was trying to pretty up the files, and that it was "poor judgment."[119]

The information in the backdated letters was similar to the information contained in the booklet entitled "Callan Associates Inc., Massachusetts Teachers' And Employees' Retirement System Investment Manager Evaluation-Equity May 1991" which the Deputy Treasurer had presented to the OIG's staff in an interview on November 25, 1992. This booklet, containing an evaluation of the same twelve candidates for domestic equity manager, appeared to be a timely analysis of the qualifications of the finalists that was used during the competition. It was represented as such by Deputy Treasurer Kaseta and First Deputy Treasurer Trimarco at the November 25, 1992, meeting with the OIG.

The OIG's staff called the authenticity of this report into question when it later discovered that the report contained data about a candidate firm that Callan could not have possibly included in such a report, since the firm had not submitted a bid until after the report was allegedly published and copyrighted. This report, dated May 1991, included data and detailed information about Numeric, a firm which did not file its response to the Department's RFP until June 13,

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[118]Dickinson. Interview: 126-127.

[119]Robert Weinberg, Esq., and Ian Lanoff, Esq. Meeting with the OIG, February 8, 1993.

1991. Those documents submitted to the OIG by Callan reveal that the information contained in its May 1991 report was derived from Numeric's response to Callan's Investor Manager Questionnaire submitted on September 27, 1991, over three months after its purported copyright date.[120] In a letter, shown in Exhibit C, from Callan to Numeric on September 23, 1991, Callan stated:

> As you know, Callan has been directed by Mr. Steve Kaseta and Staff at MASTERS to prepare a profile of your firm. Apparently we have only cursory information, and in any event we do not have any of the small cap performance figures.

The OIG's staff asked the Department's attorneys to determine the production date for this document. The attorneys subsequently reported to the Department's staff that Callan had produced this report, at the Department's request, in the summer of 1992, a year after the contract awards for domestic equity manager had been made.[121]

The May 1991 report contained information about Numeric which exaggerated its performance record and indicated that Numeric had actually managed a small cap growth fund when, in fact, the firm had never done so, according to its own RFP response. Instead of indicating that Numeric had no previous experience in managing the type of fund for which it was ultimately hired by MASTERS, Callan substituted performance results for another kind of fund. The effect of this was to give the appearance that Numeric had a brief but extraordinary real-life performance record managing small cap growth funds. As previously stated, the results which Callan reported in its backdated report were not for a $300 million dollar small cap growth fund, as required by the RFP, but were, instead, for a $3.5 million dollar non-small cap fund

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[120]Lang Wheeler, Numeric. Telefax to Melissa Davis, Callan, September 27, 1991, enclosing Numeric's responses to Callan, Investment Manager Questionnaire 1991, (Undated): (000354), Files of Numeric.

[121]Robert Weinberg, Esq., and Ian Lanoff, Esq. Meeting with the OIG, February 16, 1993.

managed by Numeric for the social security administration of an unnamed foreign government.[122] In its RFP, Numeric submitted simulated returns for its "quantitative small-cap portfolio," indicating that it had only managed a small cap fund since May 1, 1991.[123]

Callan also omitted historical performance data for GSAM prior to 1990 that had been included in its letter of June 10, 1991, evaluating GSAM's qualifications to serve as a core equity manager.[124] Gordon Dickinson told the OIG's staff in his interview under oath that he could not explain why the later evaluation report, which had the same purpose of compiling the finalists' investment history, skipped data for GSAM and Numeric that was in the earlier letters.[125]

The May 1991 backdated report also contained information which was not included in GSAM's proposal. For example, the returns used in the letters and the May 1991 report portraying GSAM as a core equity manager, show it making a slight gain (i.e., 0.66 percent) in the most recent year, 1990.[126] GSAM's returns in its proposal to become a large cap value manager showed that it **lost** money (i.e., 2.43 percent) in 1990.[127]

GSAM's results in its proposal would have automatically disqualified it from the competition because GSAM did not meet the established "bogey" in the RFP for three of five

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[122]Numeric, Answers to Questionnaire, (June 12, 1991): 7, Files of Numeric.

[123]Ibid.

[124] Callan, Investment Manager Evaluation-Equity, (May 1991): 61-62. For a comparison see Gordon E. Dickinson, Callan. Letter to Mr. Steve Kaseta, concerning Callan's evaluation of GSAM, June 10, 1991: 5, 6, Files of the Department.

[125]Dickinson. Interview: 121.

[126]Gordon E. Dickinson. Letter to Mr. Steve Kaseta, concerning Callan's evaluation of GSAM, June 10, 1991: 5. Callan, Investment Manager Evaluation-Equity, (May 1991): 61.

[127]GSAM, RFP Response, (May 23, 1991): 37, "Performance," 1. "Annualized Performance Returns," Files of the Department.

annual periods.[128] Yet, the Department provided information to the OIG, cited in Exhibit B, which showed GSAM with the best performance results in the large cap value category. These returns, as mentioned above, were not the three-year and five-year results for large cap value stated in GSAM's proposal of May 1991.

Furthermore, the Department presented the results in Exhibit B to the OIG as actual three-year and five-year performance records for the twelve finalists in the domestic equity RFP competition. The written introduction to Exhibit B entitled "Domestic Equity Management," previously cited, states:

> The following investment managers were selected based on actual past performance (3-year and 5-year average annual returns) . . . .

In fact, the Department did not list the actual past performance for two firms, both of which were hired by MASTERS. GSAM's data was simulated, not actual, for three and one half of the five years reported in Exhibit B. Numeric's results were entirely simulated.[129]

Finding 4: The Department did not adequately use the services of its consultant.

The OIG found that the Department did not require Callan to fully perform the services required in a "Manager Search" under the terms of its contract with the MASTERS Trust. The Callan contract contained an optional provision for the firm to provide "search and screening services for new and/or additional investment managers required to meet MASTERS' existing

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[128]Ibid. The OIG calculated GSAM's returns for the five annual periods ending December 30. 1990, from the data presented in its RFP response for its value product..

[129]Lang Wheeler, Numeric. Telefax to Melissa Davis, September 27, 1991, enclosing Numeric's responses to Callan's <u>Investment Manager Questionnaire 1991</u>, (Undated): 000369, Files of Numeric.

or newly defined objectives."[130] The fee for that service would be $20,000, over and above its annual fees totalling $180,000, for its core consulting services.[131] Callan's contract contained the following commitments under this optional provision:

> Callan will work with MASTERS to develop appropriate criteria prior to any search. A due diligence committee of senior Callan consultants will select a group of candidates from a preliminary list compiled from Callan's database.
>
> Callan will prepare a search report comparing candidates. The documentation shall include a statement of applicable policy and agreed criteria, a summary of manager universe used in the search, and a brief summary of the strengths of each of the finalists. Callan consultants will arrange and participate in interviews with a group of finalists, if requested to do so, and provide advice in the final selection process.[132]

Although Callan charged for this service, Gordon Dickinson testified under oath that a Callan due diligence committee did not produce a preliminary list of candidates, as promised in the firm's contract. He said:

> In this initial search, in the domestic search that you're talking about, the process that you described in several different ways was not followed step by step. As I said, the staff felt at that time that they really wanted to control the process themselves. Our role was really more to support that process in the ways that we could, to the extent that they permitted us to do so.[133]

He also stated:

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[130]Callan, Agreement, (July 31, 1990): 3.

[131]Callan, Agreement, (July 31, 1990): 4.

[132]Callan, Agreement, (July 31, 1990): 3.

[133]Dickinson. Interview: 26-27.

As I've said essentially they did the search themselves.[134]

This statement contradicted Mr. Kaseta's comments in his interview with the OIG in which he stated that Callan, though it could not dictate to the State, had as much weight as the State on the selection committee.

Mr. Dickinson also indicated that Callan did not recommend firms which should have received the RFP, and that he did not know the source of the Department's mailing list of prospective managers. Nor did Callan appear to have much influence on the development of the selection criteria prior to the issuance of the RFP. Dickinson told the OIG that Department employees constructed their own RFP using some samples of RFP's provided by Callan and an RFP from another source. He said that he read the RFP and made "some minor suggestions . . . probably some cosmetic suggestions."[135]

The OIG asked Dickinson in his interview if the Department gave Callan all of the proposals to review. He responded:

> We got -- I know we got some, we sent them back. As I say, this process wasn't documented in the way that a full process would have been. Therefore, I can't tell you that's absolutely certain. I believe we did, but I really have no way of going back and checking that.[136]

Describing Callan's review of those proposals which the firm received, Dickinson acknowledged:

> As I say, we didn't follow the process that we would prefer to follow, which was to take it through a formal due diligence committee, but the people in the research

[134] Dickinson. Interview: 150.

[135] Dickinson. Interview: 21.

[136] Dickinson. Interview: 38.

> group that I mentioned I believe did look at most of these RFP's - - I think did look at all of them, and we came back with our sort of impressions. . . .[137]

Dickinson characterized Callan's review of the proposals submitted in response to the MASTERS RFP as "informal," a phrase he repeatedly used to characterize Callan's role in this process:

> . . . If we had done it formal, I would have meant that we had produced what I'll call a due diligence package for a due diligence committee, and we would have had a conference call meeting with regard to that package and we would have made some judgments in a formal sense with our whole organization.
>
> In this case, we really went through them, I think it's fair, to look for discrepancies, for things that we thought were signals of problems, more to give them some insight rather than to say that, we think this is the best group of candidates out of the RFP responses.[138]

In response to the question asked by the OIG, "Was there a product that resulted from that informal review?" Mr. Dickinson replied, "No. Our input was entirely informal into this search."[139]

The OIG asked Dickinson whether he pointed out any discrepancies to the Department between the Callan database and the performance numbers in the proposals. Dickinson stated that Callan had done a check to make sure that the performance numbers reported by each applicant were in line with information in the Callan database.[140] He added that this information was conveyed to the Department in regard to each applicant.[141]

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[137]Dickinson. Interview: 29.

[138]Dickinson. Interview: 32.

[139]Ibid

[140]Dickinson. Interview: 41.

[141]Ibid.

Dickinson stated specifically in response to the OIG's question regarding discrepancies pointed out to the Department:

> Well, one thing that became very clear was that the numbers -- the performance that we have in our data base, which are supposedly composite results for managers, were often different from what had been received in the RFP.
>
> And we did try to resolve that in many cases, and in some cases we were unable to resolve it. But that was one thing that came up. Other things may have, and I frankly can't remember.[142]

The OIG found only a few Callan reports which were produced contemporaneously with the MASTERS domestic equity search and not created at a later date and subsequently backdated. The only analysis of managers' qualifications which Callan appears to have created at the same time as the search was the two-page "MASTERS Domestic Equity RFP Score Sheet" for each of the three RFP categories: Large Cap Growth, Large Cap Value, and Small Cap Growth.[143] The scores sheets scored each manager in relation to the qualifications stated in the RFP. Callan provided only one of these score sheets, the one for Large Cap Growth, to the OIG in response to its document request for materials related to the Department's procurement of investment managers. This score sheet indicated that two firms, MFS and Equitable, which the Department retained, did not meet the performance requirements in the RFP. Failure to meet such standards should have automatically disqualified these firms from the competition.

Mr. Dickinson stated that he believed that Callan had also created score sheets for Large Cap Value and for Small Cap Growth to the Department. These score sheets, if they had been prepared, would presumably have shown that Callan had notified the Department that certain candidate firms failed to meet the RFP requirements, just as the large cap growth score sheet had shown. According to Mr. Dickinson, he provided these score sheets to Deputy Treasurer Kaseta

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[142]Dickinson. Interview: 33.

[143]Callan, "MASTERS Domestic Equity Score Sheet, Three RFPs for Larger Cap Growth, Large Cap Value, and Small Cap" (Undated), Files of Callan.

and Mr. Baker.[144] An attorney for the Department maintained in a letter to the OIG dated April 28, 1993, that Callan did not provide the Department with these score sheets.

Despite its fiduciary responsibility as outlined in its contract with MASTERS, Callan did not inform the members of the PIC that several of the firm had not met the standards in the RFP. Mr. Dickinson defended this position by saying that Callan had made no recommendations to the PIC and that the "managers that were included in the final search were the choice of the staff."[145] Mr. Dickinson reiterated, "They were not Callan's choice."[146]

That Callan realized the Department only wanted limited outside input, and thus complied, is evident from the memorandum quoted below. This memorandum which refers to the scoring booklet entitled "Callan Associates Inc. Investment Manager Evaluation - Equity," prepared for the Massachusetts Teachers' and Employees' Retirement System, dated June 1991, and which appears to have been produced at the time of the search, is from a Callan analyst, Peggy Newton to Mr. Dickinson. The memorandum, dated June 12, 1991, the day before the oral interviews commenced, refers to Ms. Newton's conversation with Jim O'Leary, the Callan Vice President, who was formerly the account representative for the MASTERS Trust account:

> On Wednesday I had an opportunity to speak with Jim O'Leary and ran the MASTERS situation by him. As we spoke to more firms, not only did we learn they had requested net numbers, but some people were submitting an individual account, others had put together a special public funds composite, etc. **The creativity was remarkable.** He suggested that we only submit the Q & A pages and the philosophy/strategies -- not any performance numbers. **His reasoning is that this whole process is extremely political and they probably already have some favorite firms that they want to hire. If we come in showing numbers which do not support their wishes, we could really find ourselves in the political hot seat.** By putting together a nicely bound scoring book, they will at least have something with the Callan logo in front of them.

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[144]Dickinson. Interview: 54.

[145]Dickinson. Interview: 144.

[146]Ibid.

Lots of luck?[147] [Emphasis added.]

Mr. Dickinson attributed Ms. Newton's remarks to "speculation."[148]

Finding 5: The Department sacrificed additional earnings of at least $44.8 million by violating the RFP rules.

By passing over the legitimate winners of the competition and awarding contracts to six firms which did not qualify under the RFP rules, the Department sacrificed additional earnings of at least $44.8 million, and as much as $59.7 million, in the 18-month period following full investment of the pension funds, depending upon the Department's allocation of contracts among the six legitimate winning firms.

The OIG compared the investment performance records of the firms hired in violation of the RFP rules to those of the six firms which were deemed to be top-ranked competitors, among those firms which qualified under the RFP rules, by the Department and Callan during the competition.[149] The OIG did not make any independent determination about which firms were most qualified; instead, it relied on the determination made by the Department and Callan, as indicated by the records of the RFP competition.

These post-contract performance records of the passed-over firms demonstrates that they substantially outperformed the six hired firms in the six quarterly periods from the fourth quarter

[147]Peggy Newton, Callan. Memorandum to Gordon Dickinson, "MASTERS," cc: Jim O'Leary, (June 12, 1991), Files of Callan.

[148]Dickinson. Interview: 129.

[149]Large Cap Growth: IDS and Fayez Sarofim; Large Cap Value: Wertheim and Fleet/Norstar; Small Cap Growth: Fidelity and Fiduciary.

of 1991 to the first quarter of 1993.[150] According to actual MASTERS performance results reported by Callan, the six firms hired in violation of the RFP process cumulatively under-performed the Standard & Poor's 500 Index by 6.19 percent during this period.[151] (See Chart 1 in the Appendix to this report.) The superior cumulative performance results of the top-ranking six firms, which were passed over in the competition, stands in marked contrast to those results. These firms outperformed the Standard & Poor's 500 Index by 3.46 percent, according to results that they reported to OIG by those firms.[152] (See Chart 2 in the Appendix to this report.)

In the competition for large cap growth manager, the Department awarded contracts to two firms which did not meet the RFP standards: MFS and Equitable. The Callan "Masters Domestic Equity RFP Score Sheet, (Larger Cap Growth)" ranked Fayez Sarofim and IDS in first and second place among the competitors for the contract. Both of these firms met the minimum RFP criteria for the competition. OIG therefore used these firms for the analysis since they represented the qualifying firms which were top-ranked by the MASTERS selection process.

In the competition for large cap value manager, the Department awarded contracts to two firms which did not meet the RFP standards: GSAM and Greaves. The Department chose two

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[150] The first quarter of 1991 was the first period in which the funds were fully invested. The first quarter of 1993 was the last period for which data was available when the OIG analysis was done.

[151] Callan, Investment Measurement Service, Massachusetts Teachers' and Employees' Retirement Systems, Executive Summary, (September 30, 1992): 25-29; Callan, MASTERS, Executive Summary, (December 31, 1992): 23-26. Callan, MASTERS Portfolio Review (March 1993). The OIG asked Callan to provide the information in its database used in the domestic equity search. Callan told the OIG that the information in its database at the time of its search no longer existed and, instead, attempted to re-create this data. The OIG did not use this new data provided by Callan in the preparation of this report.

[152] In May of 1993, OIG contacted each of these six firms and requested that they submit actual performance results of the funds which they had proposed to use in the MASTERS competition. The analysis is based on the information submitted and has not been audited by OIG.

other firms as finalists, Wertheim and Fleet/Norstar, which met the RFP requirements. OIG used these two firms for the analysis since they represent the only two firms which (1) were selected by the Department as finalists; (2) met the RFP requirements; and, (3) did not receive contracts.

In the competition for small cap growth manager, the Department awarded contracts to two firms which did not meet the RFP standards: Numeric and Morgan Stanley. The Department chose two other firms as finalists, Fidelity and Fiduciary, which met the RFP requirements. OIG used these two firms for the analysis since they represent the only two firms which (1) were selected by the Department as finalists; (2) met the RFP requirements; and, (3) did not receive contracts.

Had the Department simply followed the RFP rules and awarded the same number and size of contracts to the legitimate winners of the competitions, the pension fund would have earned between \$44.8 million and \$59.7 million more in the following eighteen months.

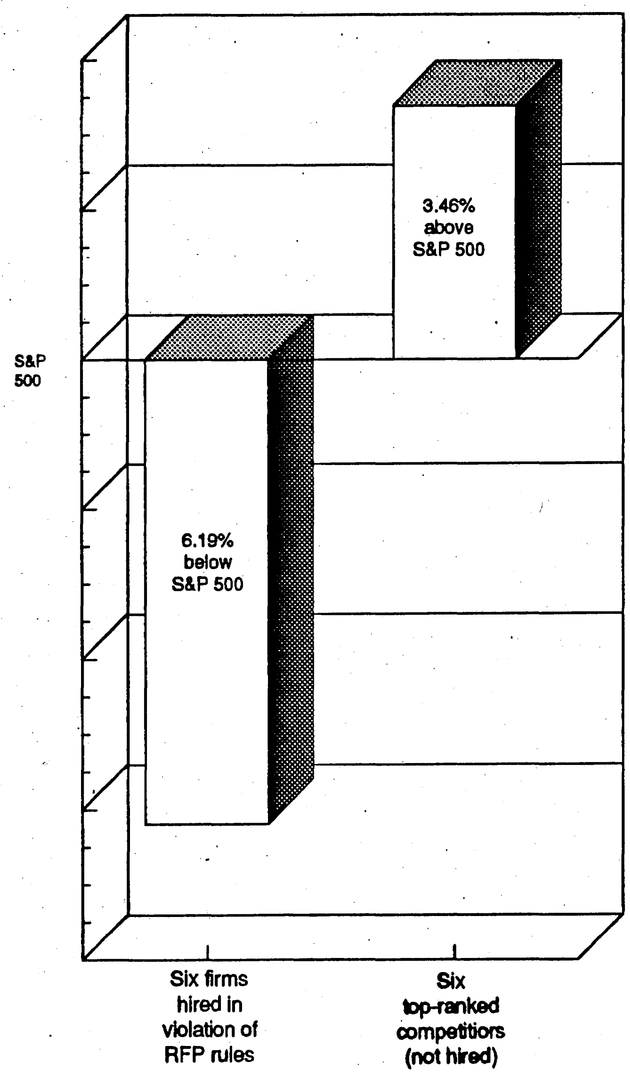
Does this represent "20/20 hindsight"? No. The rules governing the selection of managers were created ahead of time and included in the RFP. They established well-defined search and selection procedures and minimum standards on which the PIC could rely in making its decisions. These calculations simply show how much more would have been earned had those rules been followed. (See Exhibit D on the following page.)

Finding 6: The Department disregarded the minimum performance criteria in a later RFP for the procurement of global fixed-income management services.

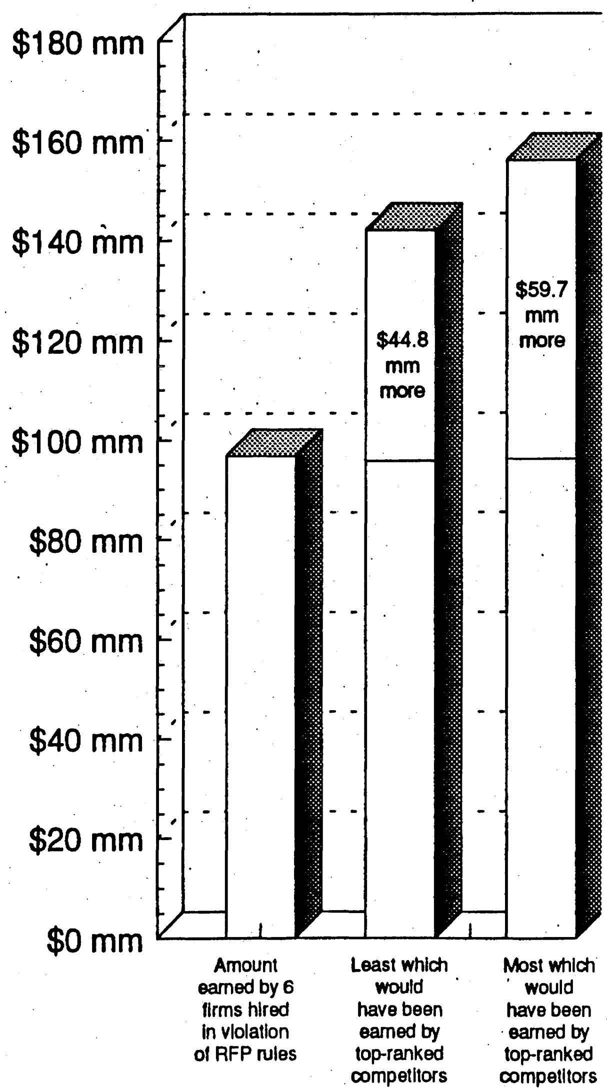
The OIG conducted a preliminary review of a later procurement for global fixed-income investment managers which showed that the Department hired two out of three managers which did not meet the minimum performance requirements in this particular RFP. MFS acknowledged in its proposal that it did not meet the minimum requirements in this RFP for three of five annual periods (i.e., achieved a rate of return greater than the "established bogey" for three of five

Exhibit D

During the six quarterly periods after the retirement funds were fully invested, the six firms hired in violation of RFP rules substantially under-performed the top-ranked firms passed over for contracts.



The Department sacrificed additional earnings of at least $44.8 million, and as much as $59.7 million, over 18 months, by violating RFP rules.



annual periods). Another firm, Scudder, which received a contract to manage plan assets did not "formalize" its management of international bond funds until 1988, and thus did not submit any five-year performance results as required by the Department RFP.[153] Scudder also missed the benchmark in the RFP for one of the three annual periods (i.e., the period ending June 30, 1989) for which it submitted investment results for its global bond product.[154] Despite these violations of RFP requirements, the minutes of the March 13, 1992, PIC meeting show that Mr. Kaseta informed the PIC that these firms met the requirements of the RFP:

> Mr. Kaseta proposed three managers for the fixed income management portion for our global portfolio. They are Putnam Company, Scudder, Stevens & Clark and Massachusetts Financial Services. These managers are being proposed to the Committee as a result of MASTERS Trust's search conducted from 11/91 through 3/92. In this search MASTERS received proposals from 24 firms (who had qualified to propose because they had achieved the top 33 percentile performance over the last five years, **and had met all the other requirements of the Request for Proposal prepared by the MASTERS Trust for the search) and selected 7 for oral presentations as finalists.** Callan assisted MASTERS Trust in the search. Two of the firms, Putnam and Scudder, Stevens & Clark are new to MASTERS Trust. The third, Massachusetts Financial Services, is currently the manager of an international fixed income portfolio for us, and as a result of the search, their performance warranted that we retain Massachusetts Financial in the mix.[155] [Emphasis added.]

The evidence suggests that, despite Mr. Kaseta's endorsement, MFS's rate of return for its MASTERS' global fixed-income portfolio lagged behind those of other finalists. MFS had not only failed to meet one of the minimum requirements in the RFP but had the worst performance results for the last year, last three years, and last five years ending June 30, 1991, of the seven finalists for global fixed-income manager evaluated by Callan. While MFS had

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[153]Scudder, Stevens & Clark (Scudder), RFP Response: Style: "Active Global Fixed Income," (November 13, 1991): "Minimum Criteria," (2), "Table 1." Files of the Department.

[154]Scudder, RFP Response, (November 13, 1991): "Table 2." Files of the Department.

[155]PIC Meeting, (March 13, 1992): 2.

claimed in its proposal to MASTERS that its five-year performance results for its global fixed income product exceeded the benchmark in the RFP, Callan's report showed returns for MFS which failed to meet this benchmark. MFS also had proposed the highest fees of any competing firm.[156]

[156]Department, RFP, (November 1, 1991): 6. MFS, RFP Response: Style: "Global Fixed-Income Management," (November 15, 1991): 2-3. Files of the Department. Callan, "MASTERS Global fixed Income Preliminary Results," (Undated), Files of Callan. Callan, Investment Manager Evaluation - Global Fixed Income Finalist Book, Massachusetts State Teachers and Employees Retirement System, (January 1992): 23.

CONCLUSION

The State's public pension law, M.G.L. c.32, §1, defines a "fiduciary" as "any person who exercises any discretionary authority or discretionary control respecting management of the funds of any retirement system or exercises any authority or control respecting management or disposition of its assets." This provision thus makes managers subject to the fiduciary standard of conduct codified in M.G.L. c.32, §23, because they carry out designated responsibilities which gives them control over the disposition of plan assets. As a fiduciary, the Department of the State Treasurer should measure up to this standard of conduct and act in a financially responsible manner.

The employees of the Department of the State Treasurer disregarded this fiduciary standard and the competitive procurement process which they had established, and as a consequence, made decisions regarding the selection of managers which could potentially diminish the Trust's earnings. This was done despite the presence of a clearly articulated fiduciary standard.

The credibility of the Commonwealth is damaged when the actions of its employees result in an unfair and biased procurement, and when attempts to justify decisions cause the creation of backdated documents. Clearly, the public pension law alone will not ensure that financial services are procured in accordance with sound, comprehensive, accountable procedures.

RECOMMENDATIONS

The OIG's recommendations are as follows:

1. **The PIC should terminate the contracts of existing domestic equity managers which did not originally meet the minimum qualifications in the May 1991 RFP or which submitted simulated data in response to the original RFP.**

2. **The Governor and the Legislature should expand the membership of the PIC to include representatives of State employees and State retired teachers in order to ensure increased oversight by those most affected by the Trust's performance.**

3. **The Legislature should enact and the Governor should sign the OIG's legislative proposal, House No. 132 of 1993, which would compel the Department to competitively procure all financial services, including pension investment management services, and to provide substantive guidelines for the evaluation of proposals.**

APPENDIX

CHART 1

ACTUAL AMOUNT EARNED BY SIX FIRMS HIRED IN VIOLATION OF RFP RULES:

FIRM	STYLE	BALANCE 9/30/91	10/01/91- 9/30/92	10/01/92- 12/31/92	1/01/93- 3/31/93
Equitable	LCG	168,488,855	-0.02%	13.54%	1.09%
MFS	LCG	164,423,932	2.91%	12.11%	0.98%
GSAM	LCV	101,780,001	5.50%	6.19%	5.64%
Greaves	LCV	51,576,727	10.85%	7.77%	0.56%
Numeric	SCG	26,389,913	16.37%	22.30%	9.07%
Morgan Stanley	SCG	105,759,691	-3.58%	11.49%	-6.01%

18 month gross return for six firms hired in violation of RFP: $96,729,038

CHART 2

Option 1: Least amount sacrificed by not following RFP rules:

FIRM	STYLE	Allocation 9/30/91	10/01/91- 9/30/92	10/01/92- 12/31/92	1/01/93- 3/31/93
IDS	LCG	164,423,932	10.30%	9.50%	4.32%
Fayez Sarofin	LCG	168,488,855	14.04%	2.80%	-2.70%
Wertheim	LCV	51,576,727	12.58%	4.60%	5.50%
Fleet/Norstar	LCV	101,780,001	12.75%	6.87%	2.19%
Fidelity	SCG	105,759,691	7.88%	12.39%	3.93%
Fiduciary	SCG	26,389,913	18.80%	16.85%	3.39%

18 month gross return for six non-hired firms (least): $141,483,729

Least amount sacrificed over 18 months by not following RFP rules: $44,754,691

Option 2: Greatest amount sacrificed by not following RFP rules:

FIRM	STYLE	Allocation 9/30/91	10/01/91- 9/30/92	10/01/92- 12/31/92	1/01/93- 3/31/93
IDS	LCG	168,488,855	10.30%	9.50%	4.32%
Fayez Sarofin	LCG	164,423,932	14.04%	2.80%	-2.70%
Wertheim	LCV	101,780,001	12.58%	4.60%	5.50%
Fleet/Norstar	LCV	51,576,727	12.75%	6.87%	2.19%
Fidelity	SCG	26,389,913	7.88%	12.39%	3.93%
Fiduciary	SCG	105,759,691	18.80%	16.85%	3.39%

18 month gross return for six non-hired firms (most): $156,425,418

Greatest amount sacrificed over 18 months by not following RFP rules: $59,696,380

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