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October 18, 2006

Joseph I. Martin
Deputy Executive Director
Public Employee Retirement Administration Commission
5 Middlesex Ave., 3rd floor
Somerville, MA 02145

Dear Mr. Martin,

Having assisted the Public Employee Retirement Administration Commission during the course of the investigation into the loss of $37 million by the Middlesex Retirement System, I welcome the opportunity afforded by this investigative hearing to offer written testimony on the investment and recordkeeping practices of retirement boards as well as the actions of board members.

Prior to getting into specifics, I first wish to commend PERAC for its thorough and authoritative Interim Investigative Report. It provides a finely detailed, dispassionate description of the various parties' roles in the transactions that led to the Middlesex Retirement System's large losses.

As outlined below, certain actions taken or failures to act by Middlesex board members may represent breaches of fiduciary duty. As you know, PERAC is conducting separate proceedings to determine whether six current or former board members have violated their fiduciary duty. To answer this question, it is vital that the PERAC commissioners have all relevant information. MRS board members' failures in connection with a $37 million loss are certainly relevant and central to answering that question. I ask you to consider referring the fiduciary breaches, highlighted below, to the PERAC commissioners.

In addition, the hearing notice states PERAC is examining "the level of cooperation of various parties in the investigations." My staff has spent considerable time investigating the receipt by two local individuals, Ronald Whitham and Thomas F. Kelly III, of $2.8

million in undisclosed commissions connected with the Cambridge Financial Management account. Over the course of the investigation, Middlesex officials displayed a lack of cooperation regarding their awareness of Mr. Kelly's involvement with Cambridge Financial Management. Appended is a summary describing this lack of candor.

Several facts regarding Middlesex's investment with Cambridge Financial Management stand out as notable and deserve special attention by the commission. These highlights are all taken directly from the Interim Investigative Report.

1. The Middlesex Retirement Board failed to adequately monitor the Cambridge Financial Management account (p. 33). Cambridge Financial Management's president, James Kneafsey, violated his contract in several ways for more than two years, amassing millions of dollars in losses. These violations were evident from Mr. Kneafsey's own trading reports, sent monthly to Middlesex via Mellon, the custodian bank.

   For example, Cambridge Financial Management's August 1999 investment guidelines from Middlesex explicitly prohibit writing options (p. 41). By the spring of 2000, Mr. Kneafsey's reports clearly indicated he was writing options. This breach of the contract was brought to the Middlesex board's attention by its consultant, Wainwright Investment Counsel, with a warning that writing options was a risky practice that could lead to "greater losses." Had the Middlesex board members enforced their own rules on Mr. Kneafsey, his reckless activity would have been exposed earlier and Middlesex's losses would have been limited.

2. Mr. Kneafsey used obviously inflated market values in his monthly reports in order to disguise his trading losses. In its Interim Investigative Report, PERAC explains how Mr. Kneafsey, beginning in early 2001, assigned false market values to his currency positions (p. 57). Together, these fake values invariably showed an "unrealized gain" – a number that masked an actual loss. A comparison of successive monthly reports would have exposed the fabricated values but Middlesex never made such a comparison.

   The section of the Interim Investigative Report beginning on page 57 shows numerous dramatic examples of this practice, most taken from the end of Mr. Kneafsey's tenure. For instance, the stated value of an option rose from $33,000 when Mr. Kneafsey acquired it on March 25, 2003 to a reported $1,245,000 just six days later. The following month's report reported the option expired on April 3, worthless.

   The practice of assigning inflated values to currency positions was under way – and detectable – by 2001. A comparison of successive monthly trading statements turns up many examples of very short-term positions that ostensibly rise dramatically in value by the end of one reporting period, only to have the "unrealized gain" vanish within a matter of days. For example, between Nov. 23

and Nov. 26, 2001, Kneafsey acquired options on yen for $407,400. His Nov. 30, 2001 report valued the holding as an unrealized gain of $2.072 million. The following month's report showed that the option expired worthless on Dec. 4, 2001.

3. Middlesex failed to comply with a number of PERAC rules. For instance, PERAC required Middlesex to meet annually with Cambridge Financial Management, a measure designed to prompt a review of the vendor's compliance with investment guidelines and other rules. Middlesex did not meet annually with Cambridge Financial Management to review compliance with the guidelines (p. 79). In addition, Middlesex required Cambridge Financial Management to submit quarterly reports, but took no action when Mr. Kneafsey failed to submit those reports (p. 72). Also, as PERAC's Interim Investigative Report makes clear, Middlesex signed a contract with Wainwright that effectively indemnified the consultant against any losses, despite a prohibition on such clauses (p. 46).

4. Middlesex board members failed to act when anomalies occurred. In July 2001, Mr. Kneafsey sent a report to Middlesex. It was his first report to Middlesex in a year and the last he ever provided, despite a contractual requirement to provide quarterly reports. Mr. Kneafsey's report contained conspicuous indicators that the account had deviated dangerously from its stated purpose.

   For instance, the report states the account recorded a 109.9 percent gain in value in March 2001 followed by a loss the following month of 45.4 percent (p. 76). These returns would be remarkable in a venture capital account. For a money manager hired to protect the value of overseas stock holdings against currency fluctuations, these returns are stunning. Middlesex's guidelines for Mr. Kneafsey set a goal of exceeding a recognized international index by 1 percent over several years and to inform the board if losses exceeded 3 percent of the portfolio. The report discloses volatility that exceeds expectations by orders of magnitude – a result that went unexplained by Mr. Kneafsey and unquestioned by Middlesex board members.

   Also glaring is what is omitted from the report. Cambridge Financial Management was required to ensure his currency positions corresponded with the holdings of Middlesex's international equity funds. Unlike prior reports, the July 2001 report did not reference the overseas stock exposures.

5. For much of the Cambridge Financial Management account's history, Mellon's monthly trading reports to Middlesex show a volume of transactions that exceeds the purpose for which Mr. Kneafsey was hired – protecting the value of Middlesex's roughly $40 million international stock holdings. In the Interim Investigative Report, PERAC states that by March 2001, Middlesex had a currency exposure of $221.9 million. Six months later, the currency exposure had grown to $487.8 million (p. 50). To put this in perspective, Middlesex's entire portfolio was worth about $550 million at this time, according to PERAC's 2001

Annual Report.

The Middlesex Retirement Board and the other parties involved in the Cambridge Financial Management account put much of beneficiaries' funds in danger and caused unprecedented losses. Middlesex board members' acts or failures to act represent breaches of their fiduciary duty to carefully oversee this account.

As I noted earlier, PERAC has scheduled separate proceedings to adjudicate whether seven individuals, six of whom are current or former board members, violated their fiduciary duty. The actions of the board members, as documented in the Interim Investigative Report, bear directly on the question PERAC will decide. I ask you to consider referring the fiduciary breaches identified during your investigation of this matter to the PERAC commissioners for inclusion in those separate proceedings.

I appreciate this opportunity to testify on a matter of great importance to the safety of a pension fund on which thousands of public employees are depending and the integrity of the pension system overall. I hope this letter is helpful in the commission's deliberations and its ongoing work.

Sincerely,

Gregory W. Sullivan

Gregory W. Sullivan
Inspector General

cc: PERAC commissioners

Appendix

In its hearing notice, the Public Employee Retirement Administration Commission states that “the level of cooperation of various parties in the investigation” is a specific focus of its investigatory hearing. A number of actions taken on behalf of the Middlesex board, including those of current Middlesex chairman Thomas F. Gibson, raise serious questions about Middlesex officials’ degree of cooperation with their regulator.

A series of actions took place following a Jan. 6, 2006 letter by the Inspector General informing PERAC about a secret arrangement that resulted in two individuals pocketing $2.8 million in fees charged to public employees’ pension funds through Cambridge Financial Management’s trades. As detailed in the letter, Ronald A. Whitham had a lucrative “introducing broker” agreement with Goldman Sachs that paid him $50 for every $1 million Cambridge Financial Management traded with Goldman Sachs. Mr. Whitham received $2.8 million from Goldman Sachs between late 2000 and early 2003. Of this, $1.9 million came from trades on Middlesex’s account. Over the same period, Mr. Whitham paid $1.4 million – half of the proceeds – to Thomas F. Kelly III, the principal of CanAm Consultants Inc., a third-party marketing firm.

The Inspector General’s January letter stated, “Middlesex Retirement System officials were apparently aware that Kelly may have had involvement in the investment that cost the system’s beneficiaries $37 million.” Middlesex board members have denied this but in the last 10 months, much more evidence has come to light substantiating Mr. Kelly’s role with Cambridge Financial Management and Middlesex Retirement System officials’ awareness of his involvement.

Mr. Kelly himself has repeatedly confirmed that he was actively working to promote Cambridge Financial Management to the Middlesex Retirement System and other pension funds when he was receiving payments from Mr. Whitham.

“I introduced Cambridge Financial to the Middlesex Retirement Board,” Mr. Kelly said under oath in a deposition in a civil suit related to the $37 million loss. In written answers to questions from PERAC, he also confirmed his role in selling Mr. Kneafsey’s management skills to the Middlesex Retirement Board.

Mr. Kelly’s contention that he marketed the currency overlay manager to Middlesex is buttressed by both documentary evidence and by others’ recollections.

In March 1998, Mr. Whitham received a letter from CanAm Consultants Inc. telling him that the Middlesex Retirement Board was in the process of selecting a currency overlay manager. At the time, Mr. Whitham was paying Mr. Kelly to promote Cambridge Financial Management as well as his own company, Alaric Corp.

The information in CanAm’s letter, which was sent two months before Middlesex’s official Request for Proposal process began, could have only come from an insider privy to discussions among the Middlesex Retirement System board members.

In addition, Gustavo Aristizabal, who as director of research at Wainwright Investment Counsel was charged with educating Middlesex board members about potential managers, said in an interview that he knew that Mr. Kelly had a relationship with Cambridge Financial Management because he'd seen Mr. Kelly during a presentation at Mr. Kneafsey's office. Mr. Aristizabal said he was never told the exact relationship between Mr. Kelly and Mr. Kneafsey but that he knew Mr. Kelly was a third-party marketer: that is, someone in the business of promoting investment managers.

Mr. Aristizabal also said he'd seen Mr. Kelly and Mr. Kneafsey together at a Middlesex Retirement System spring conference, an event typically attended by all Middlesex's board members.

Finally, Wainwright constructed a chronology of events and actions that took place following Mr. Kneafsey's death in April 2003 and the disclosure of the $37 million loss. In that chronology, Mr. Aristizabal wrote, "Called Tom Kelley [sic] (marketing representative for Cambridge Financial) and informed them him [sic] that after the burial ceremony or as soon as she deemed appropriate to have Pat Otis contact me. He indicated to me that he understood Pat was going to continue the business." Ms. Otis is Mr. Kneafsey's widow.

In an interview, Mr. Aristizabal said that his relationship with Mr. Kelly was limited to saying hello at events and that he would not have contacted Mr. Kelly without being asked.

"My only reason was somebody may have instructed me to call Tom Kelly," he said. "It must have been [someone] from Middlesex. I have no reason for calling him."

Wainwright's chronology formed the basis of a second chronology that was sent by the Middlesex Retirement System to PERAC to detail the steps it took in the wake of Mr. Kneafsey's death. For the period through May 9, 2003, these two chronologies parallel each other and, in many ways, are virtually identical – with one striking exception. Wainwright's chronology mentions the phone call to Kelly because of his role as "marketing representative for Cambridge Financial" while Middlesex's chronology to PERAC omits that entry.

Mr. Gibson, then the Middlesex Retirement System's outside counsel, now its chairman, has stated that he intentionally left Mr. Aristizabal's conversation with Mr. Kelly out of Middlesex's chronology. He explained that the entry mentioning Mr. Kelly was dated as "4/16 or 4/17", putting it several days before Mr. Kneafsey died. He also said Mr. Kelly's involvement did not seem significant at the time.

This explanation seems implausible. First, the entry mentions Mr. Kneafsey's pending "burial ceremony," making it clear that the call happened after his death. Second, any interaction with Ms. Otis, Mr. Kneafsey's business partner, clearly was significant at a time when Middlesex was trying to figure out how to manage the account. If Mr. Kelly's involvement wasn't significant to Mr. Gibson, certainly getting in touch with Ms. Otis was. Given the minutiae that Mr. Gibson copied from Mr. Aristizabal's chronology, Mr. Gibson's claim that the Kelly entry was insignificant lacks credibility.

Omitting the entry about Mr. Aristizabal's conversation with Mr. Kelly is part of a continuing pattern.

The Inspector General's Jan. 6, 2006 letter to PERAC pointed to a June 18, 2003 facsimile, provided in response to a subpoena, in which a public relations consultant working for the fund sent a copy of a Globe column on the Cambridge Financial Management scandal to Middlesex Retirement System's then-chairman, James E. Fahey Jr. On the cover page, the public relations consultant wrote, "It is good that there is no mention of Tom Kelly."

Both Ashley McCown, a principal of the public relations firm, and Mr. Fahey have stated that they were happy that Mr. Kelly wasn't mentioned because, as Mr. Fahey wrote to PERAC, he "is known to some as a controversial figure" and a mention of him would have detracted from the article.

However, in answers to PERAC, Anne Buckley, Wainwright's general counsel, acknowledged that in response to the Globe columnist's inquiries she discussed Mr. Kelly with Ms. McCown and gave her a copy of a letter describing a June 2001 marketing luncheon that Mr. Kelly hosted on Mr. Kneafsey's behalf. That letter offers clear evidence of a connection between Mr. Kelly and Mr. Kneafsey.

The decision to omit the mention of Mr. Kelly from Mr. Gibson's June 2003 chronology deserves special attention because this communication was Middlesex's first official description to PERAC of its actions following the death of Mr. Kneafsey and the discovery that he had lost $37 million. To date, Mr. Gibson has suggested that he, as the retirement board's then lawyer, made the decision to omit the mention of Mr. Kelly alone – without any guidance or direction from Middlesex Retirement Board members.

Mr. Gibson and his fellow board members continue to deny that they know anything about Mr. Kelly's role with Cambridge Financial Management.

"As far as I know, neither Mr. Kelly nor CanAm played any role in the MRB/CFM investment," each board member wrote in answer to questions posed by PERAC.

Regardless of whether Mr. Kelly is viewed by some as a "controversial figure," it is improper for Mr. Gibson and the Middlesex Retirement Board to withhold this relevant information from PERAC. It was improper in 2003 and it is improper today.

The Middlesex Retirement Board members have repeatedly claimed that Mr. Kelly had no role in their decision to invest with Cambridge Financial. Interviews, depositions and documents indicate that the board's claim is not true. This new evidence strongly suggests that at least some Middlesex Retirement Board members knew about Mr. Kelly’s role and therefore are not being candid with either their regulator or the system’s beneficiaries. That creates doubt about whether the board has cooperated fully with your investigation.