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Board of Selectmen

Press Release

Testimony concerning Middlesex Reform Legislation

Thursday, December 11, 2003

Mr. William H. "Trey" Shupert, III, member of the Town of Acton Board of Selectmen, has presented testimony regarding House No. 3584 (2003). This bill proposes "reform legislation regarding the compensation, duties and responsibilities of the Middlesex Retirement Board." The Board of Selectmen seeks passage of this crucial reform legislation to "protect the retirement funds of present and retired public employees [...] throughout the former Middlesex County."

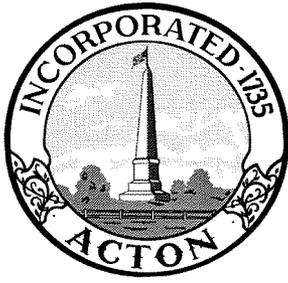
Please see the attached **written** transcript of Mr. Shupert's testimony and additional written comments not provided in the testimony.

Mr. Shupert is available for questions and interviews.

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Board of Selectmen

Testimony concerning Middlesex Reform Legislation **Transcript of Oral Testimony in Regards to House No. 3584 (2003)**

Thursday, December 11, 2003

Thank you for the opportunity to speak, Mr. Chairman and honorable members of the House Public Service Committee. At the conclusion of my remarks, I will provide a copy of this testimony, as well as a supporting memorandum from the Acton Board of Selectmen, to be included in the public record.

The Board of Selectmen of the Town of Acton very strongly supports House No. 3584 (2003), proposed reform legislation regarding the composition, duties and responsibilities of the Middlesex Retirement Board ("MRB"). The Acton Board of Selectmen respectfully requests that the Great and General Court pass this critical reform legislation as soon as possible to protect the retirement funds of present and retired public employees (and their contributing employers such as the Town of Acton) throughout the former Middlesex County.

In particular, the Board of Selectmen is extremely concerned about the significant financial losses to the Middlesex Retirement System ("MRS") allegedly resulting from a risky and speculative foreign currency investment strategy that the MRB engaged in over the course of several years. This foreign currency investment strategy, which put at grave risk, millions of dollars of hard-earned public employee retirement funds, allegedly involved possible breaches of applicable regulations and fiduciary duties.

In addition, the Acton Board of Selectmen is concerned that the MRB's acquisition and disposition of real property in Billerica, through a limited liability company, may have violated the letter, or at least spirit, of applicable PERAC regulations and public bidding laws.

In September of 2002, employer contributing member units of the MRS were advised by the MRB, that due to financial losses in the equity markets, the MRB was increasing retirement assessments for member communities in order to ensure adequate retirement fund reserves in future years. The Acton Board of Selectmen was completely shocked when we learned that the MRB mandated a 60% increase in Acton's retirement assessment. We later learned that the total average increase for the MRS's member units was 45%.

In announcing the new assessments to member communities, the MRB also simultaneously announced a change in assessment formulas. We considered this new assessment formula an action that masked the magnitude of the true financial and management problems with the MRS.

The MRB's initial response to inquiries about fund losses was that the losses were due solely to a bad economy. The MRB assured member units that the MRS pension fund was doing much better than other pension funds and that there was nothing to worry about. But as we began to investigate the financial losses, our board soon discovered that MRS financial losses had extended as far back as 1999 – almost two years before the severe downturn in the stock market. As you may remember, 1999 was one of the best performing years – ever – for stock and equities markets, yet the MRB managed to lose money in that year, and in the succeeding years since that time. The Acton Board of Selectmen alleges that the financial losses were not primarily due to the poor economy and decline in the stock market, but rather, that the losses resulted from very risky investments, mismanagement and a total lack of oversight and audit of fund managers and fund performance. In short, we believe that the MRS is out of control.

Faced with a 60% assessment increase, Acton began contacting other communities within the system to find out how other contributing employers were going to fund the huge increases in retirement assessments. However, we discovered that the new assessment formulas resulted in a majority of smaller member units receiving decreases in their assessments! Essentially, the MRB's new assessment formula penalized the minority of large employer contributor member units, in favor of the majority of smaller contributing employer member units. You will no doubt hear testimony from some small member units who oppose the reforms contained in House 3584 and who support the actions and decisions of the current MRB. This is perfectly understandable because if you were a small member unit whose retirement assessment decreased, why would you complain? I will add here that the Acton Board of Selectmen was not at all surprised when we discovered that the MRS was one of the small contributing employer member units whose retirement assessment decreased.

Almost immediately, Acton joined Billerica, Chelmsford, Weston and several other communities to lodge vigorous complaints about the assessment increases and recommend changes to the management oversight and accountability of the MRB. Yet the MRB responded that the assessments, and the new assessment formulas, were absolutely necessary to preserving future fund balances. The MRB also stressed that over time; the MRS would recoup fund losses.

Our recommendations for reform within the system were wholly rejected. The MRB will most likely testify before this committee that in rejecting our reform recommendations, the board was merely following the wishes and direction of the majority of its contributing employer units as represented by the MRS advisory council. And while that may be a true statement, it is also entirely misleading. You see, the MRB has systematically “stacked the deck” against large member units by giving each member unit – *regardless of the number of employees represented in that unit* – one equal vote on the MRS advisory board. Under this unfair method of one vote for each member unit, Acton's Municipal employee member unit which consists of several hundred employees and retirees, has the same equal vote on the advisory board as Acton's Housing Corporation employee unit that represents less than 10 employees and retirees. That is why we have proposed in House 3584 to move to a representatively weighted vote that is very common in other well-managed retirement systems. The bottom line for Acton, and other large employer units, is that the MRB has made it very difficult, if not impossible to effect meaningful change within the MRS.

As such, with no other alternatives, Acton supported the tiling of legislation to implement change within the MRS. And it was only after reform legislation of the duties and responsibilities of the MRB was filed in the House, that the MRB finally realized the level of the concern and outrage of member communities. Shortly after filing House 3584, the MRB sent a self-congratulatory notice to member communities stating that in their effort to help member units through difficult budgetary times, the MRB was taking the extraordinary action of reducing member unit assessments for FY 2004. This was nothing more than an attempt to appease communities. While it is true that Acton's original FY 2004 assessment of 60% increase was reduced under the new plan to a 33% increase, the revised 33% assessment increase alone, consumed nearly 40% of Acton's entire allowable Prop 2.5 increase property taxes. By reducing member unit assessments, the MRB completely misjudged our concerns. Our issues were about mismanagement, lack of communication to member units, lack of MRB accountability and a lack of representation of member units.

Please understand that you cannot tell member units on one day that retirement system losses are so significant as to require dramatic increases in assessments to preserve future fund reserves, and then turn around – almost the very next day – specifically, after the reform legislation was filed – and announce a reduction in unit assessments saying that losses could be made up over time. Not only were assessment increases reduced for FY 2004, in a valiant attempt to quell a revolt from the few large member units who were shouldering most of the entire MRS's assessment increases, the MRB went even further. Against the MRB's own pension consultant's advice, the MRB guaranteed that assessments over the next three years would increase by only 4.6% annually. Interestingly enough, in another now predictable action by the MRB, Acton recently received notification that our FY 2005 assessment was going to increase by 14%; not the 4.6% that was guaranteed to member units last year. Mr. Chairman, even President Ronald Reagan would call this "voodoo economics".

The information from the MRB on its operations, processes, investment strategies and oversight procedures has been, to say the least, less than forthcoming. Rather than respond, honestly and openly, to member unit inquiries and then working cooperatively to effect meaningful reform within the MRS, the MRB instead accused those member units who support House 3584 of sensationalizing problems with the pension system. In fact, the MRB has told anyone who would listen that the MRS pension fund has performed much better than other funds, in that it lost less money than other funds during the current economic downturn. And initially, based upon the little information we received, it did look like there was some validity to their claim that at \$35 million in losses, the MRS had performed marginally better than some other systems. However, we later learned that the \$35 million was only the "tip of the iceberg" and that in fact, losses were almost \$75 million dollars! And to this day, that number continues to rise every time new information is released by the MRB.

Mr. Chairman, the fact is that at the time the MRB was trying to reassure member communities that fund losses were manageable and due solely to the downturn in the stock market, the MRB had no idea, whatsoever, of the magnitude of the fund's losses. It was most disappointing to the Acton Board of Selectmen that the MRB actually seemed surprised when new losses are discovered. To our board, it was the perfect example of why we believe that the MRB has been "asleep at the switch" for some time. It quickly became apparent that the MRB has no procedures or processes to closely monitor the performance of its investments. To put this as simply and

succinctly as I can, the MRB was so far out to lunch on what was happening to their investments, that they were never going to make it home for dinner.

Not only were fund losses substantially higher than what the MRB was reporting, we later learned, in a somewhat comical coincidence, and have since alleged, that the MRB breached its fiduciary duty under M.G.L. Chapter 32 by purchasing a new headquarters facility in Billerica. Imagine the Acton Board of Selectmen's surprise, amidst all of the contentious debate with the MRB about fund mismanagement and millions of dollars in fund losses, to receive an invitation to attend a celebration of the grand opening of their new multi-million dollar facility. And you would not know that the MRS has lost \$80 to \$90 million in the last 4 years by touring the new MRS headquarters. It has been described it as "overly plush, but not ostentatious."

We expect that the IBPO may testify on behalf of the MRB and make a strong statement of support for their management capabilities. This would be consistent with their written statement of support that the IBPO sent to MRS retiree members. However, I respectfully advise the Committee that the Acton Board of Selectmen views this support as highly suspect, since the IBPO's initial letter was sent shortly after the IBPO entered into a lease with the MRB and moved its headquarters to vacant space with the MRB's recently purchased new headquarters building in Billerica. Yet under Chapter 32, section 2 1 .01 (10): Prohibited Investments, the MRB is expressly forbidden from making a direct purchase or lease of real estate. When we learned that the MRB had leased space to the IBPO, we filed a public records request for copies of lease documents. That written request was made over 6 months ago and to date, we have yet to receive any information on the IBPO lease.

Also under Chapter 32, the MRB is expressly forbidden from making a purchase of options, or investing in options, as a means of hedging against such fluctuations in the value of the dollar. Moreover, and I am quoting directly from the statute, "[s]peculative currency positions unrelated to underlying portfolio holdings are **strictly prohibited.**"

We have learned that on October 15, 1998, the MRB entered into an Investment Management Agreement with Cambridge Financial Management, Inc. ("CF"), through which MRB authorized CF to invest a portion of the MRS investment portfolio, which currently has a value of around \$500 million, in a so-called "hedge program." Specifically, MRB retained CF to "buy and sell futures and option contracts in foreign currencies." According to that Agreement, CF was given \$48 million by the MRB to invest in the hedge program.

Under the Agreement, CF allegedly invested MRS funds in a variety of foreign currency options contracts. CF reportedly used two brokerage firms to handle trades on its behalf, Mellon Bank Capital Markets Group ("Mellon Brokerage") and Goldman Sachs. At this time, MRS had apparently retained Mellon Financial/Boston Safe Deposit Company as its custodian bank reportedly responsible for providing MRS with regular financial statements, indicating the value of MRS's various holdings, including the investments being managed by CF. According to a Complaint tiled by MRS against Mellon Financial by MRS in Middlesex Superior Court on July 10, 2003, MRB was informed on April 30, 2003, that it had a "short exposure" during the months of February, March, and April 2003 of over \$19 million due to unfavorable option contracts that CF had entered into on behalf of MRB. MRB reportedly subsequently discovered that it had a short exposure on contracts with Mellon Brokerage equal to almost \$18 million.

It appears from the MRB Complaint, the Agreement and related information that CF allegedly purchased options. If this was in fact the case, CF - on MRB's watch and under the MRB Agreement - violated PERAC's strict prohibition on – again, I quote directly from the statute - “[f]orward currency contracts [in excess of] . . . a maximum 25% of the international portfolio non-dollar holdings at market value” and/or on “[s]peculative currency positions unrelated to underlying portfolio holdings” which are “strictly prohibited.”

I want to again emphasize that the Acton Board of Selectmen, while concerned about huge losses, is even more concerned that the MRB has no idea of how its funds were invested. Why else would it authorize its fund manager, in a written agreement, to engage in prohibited investment activity under M.G.L.? And why else would the MRB have to file a lawsuit against its custodian bank, Mellon Financial to recover losses on foreign currency options that it did not know it had incurred? As honestly and sincerely as I can say this, Mr. Chairman, I'm not making any of this up. We have confirmed this information through actual documents filed in the lawsuit.

Let me also emphasize that the MRB has been almost non-responsive to numerous official written requests for information under the Mass. public records law. Member units have requested copies of official public records and files relating to the purchase of the new headquarters, management financial statements and statements on international investments. For the most part, our requests have been met with silence. As such, member units have expended thousands of dollars in retaining legal counsel to decipher the little information that has been made public by the MRB. I submit to you that forensic audits through public records requests are a painstakingly costly and time-consuming way to get to the truth. But one thing I have learned, throughout this on going and ever increasing mess, is that the MRB is *expert* in obfuscation and delay tactics. In *my* opinion, had the MRB been advising the Board of Directors of Em-on Corporation during the SEC and FBI investigations, Em-on would still be a well respected and publicly traded company today.

The MRB's disregard of Massachusetts public records law, while understandable, is repugnant to every public servant who abides by that law and conducts government business in an open and honest manner. I say “understandable” because our legislation to reform the MRB's duties and responsibilities calls for the termination of the Executive Director of the MRS and for the orderly transition to a new, more qualified and investment savvy MRB.

I have no doubt that you will hear passionate testimony from the Executive Director of the MRS, or his legal representative, that my allegations are nothing more than a vitriolic protest of circumstances beyond the MRB's control. But I ask that you remember that the Executive Director's primary objection to the proposed legislation involves job security – specifically *his* job security. As a Human Resources executive, I will tell you that he should be concerned about his job security. I seriously doubt that a Fidelity Investments or a Putnam Investments would hire someone who oversaw the loss of \$80 to \$90 million in highly speculative and volatile investments and didn't even know the magnitude of the losses, to manage any of their pension funds.

The Acton Board of Selectmen fully understands the serious nature of our allegations. And even though we were outraged at the continued arrogance of the MRB's actions (among other things, hiring a paid professional lobbyist with MRS funds to lobby legislators to kill this proposed reform legislation), we have nonetheless tried to negotiate a reasonable compromise with the MRB to give member units more oversight responsibility and authority in retirement fund management. Quite frankly we are tired of making commitments to keep our negotiations confidential, only to

have the MRB engage in a full-scale public relations campaign suggesting that a few disgruntled member units are sensationalizing the problems with the MRS.

Mr. Chairman, the Acton Board of Selectmen also fully understands that the stock market goes up and goes down. We are fully prepared to accept reasonable increases in retirement assessments and we understand that over time, investing in stocks and bonds is generally prudent action. Moreover, the Acton Board of Selectmen does not expect the MRS to produce investment earnings that far exceed the earnings of other pension funds, especially in difficult economic downturns. However, what we do expect - and what we have every right to expect – is that the professionals managing the investments of MRS funds are highly qualified, make financially prudent investment decisions, and are held accountable to reasonable and customary financial standards and controls.

If the MRB is allowed to continue operating independently, with no oversight and far from the view of public light, I assure you that within a few years, the MRS retirement fund will be in serious jeopardy of not being able to meet the pension obligations of an ever-increasing number of retirees within the system. If that happens, and if the MRB is successful in altering or killing House 3584, employer contributor member units will face astronomical and crippling increases in retirement assessments to maintain the solvency of the pension fund.

The reality of the situation is that no matter how poorly the MRB manages the MRS pension fund; the MRB bares no accountability or liability for fund losses. It is the employer contributor member units who bare the sole responsibility for ensuring that the fund remains solvent. As best that I can tell, the MRB functions as nothing more than a neighborhood investment club. They use employer contributions to hire fund managers to make investments on behalf of the system. If the investments produce good returns, they get to tell the world what savvy and sophisticated investors they are in predicting future market trends. And if their investments lose money, as the MRS has every year since 1999, they get to go home at night and sleep soundly knowing that it is the member units who must pay for the MRB's investment mistakes.

It is my opinion that current MRS, under the direct management of the current MRB is, quite simply, “free, fair and fixed”. By that I mean that there is absolutely no representation by any employer-contributing unit on the MRB. Let me state this another way. The way the current MRS functions is taxation without ANY representation. We are given mandatory assessments each year and are required under law to contribute enough money to keep the total MRS pension fund sufficiently solvent. Yet we have absolutely no say in investment strategy, investment decisions and no oversight capability. Like I said, the best way to describe this is “taxation without representation.”

To be sure the MRB will say that the MRS has ample representation of member units and they will point out that every member unit has an equal vote on the MRS Pension Advisory Board. However, what the MRB may not mention is the fact that the Advisory Board is “advisory only” and has no authority to mandate, or even influence the MRB in any way, whatsoever.

We have proposed, in House 3584, a change in the make up of the MRB to include direct representation of member units. MRB representatives will probably tell you that this is a radical change that will threaten the very existence of the MRS. I will tell you, that the reform legislation proposed in House 3584, is not at all radical and supports the long-term, future solvency of the

MRS because it finally brings the MRS into compliance with the federal Taft-Hartley Act. I respectfully ask if it can be defined as radical to bring the MRS and the MRB into compliance with the provisions of the Taft-Hartley Act? Please note that these are the same provisions and requirements that every private pension program in the United States is required to follow.

The MRB will tell you that is absolutely critical that the people in the MRS system, run the MRS. I am sure that the MRB would be surprised to learn that as long as the employer contributing member units are allowed to serve on the MRB, the Acton Board of Selectmen fully agrees with this position. After all, we are the units who pay for investment mistakes made by the MRB. House 3584 ensures that we will have direct representation on the MRB. Again, this change does nothing more than to bring the MRB into compliance with the Taft-Hartley Act.

Speaking on behalf of the Acton Board of Selectmen, I can tell you that we are already overwhelmed, in the midst declining revenues and significant cuts to state aid, with trying to balance to our operating budgets, while maintaining reasonable services and good schools, and absorbing significant increases in healthcare costs and negotiated wage settlements with our unions. I hope you that understand that we are having a difficult time as Selectmen without having to worry about the negative financial impacts of the MRB's mismanagement of pension funds.

The employer contributor member units of the MRS – and most importantly, retirees – deserve better. Only a fundamental change to the way MRB does business can restore public confidence in the Middlesex Retirement System and help to prevent situations like this from recurring in the future. House 3584 enables that fundamental change, yet does not exceed federal and state pension standards.

In closing, after hearing all the testimony on this legislation, reviewing the full record of financial losses, allegations of mismanagement, lawsuits and counter suits, I am confident that you will correctly conclude that there is something very seriously wrong with the way the MRS is currently managed. However, I will respectfully request that before you vote on whether or not to recommend House 3584, that you ask yourself one question: “would I invest my own personal retirement savings in the MRS pension fund to be managed by the current MRB under the current fiduciary statutes? If your answer to that question is anything less than an enthusiastic “yes”, then I respectfully submit that you must support this critical reform legislation.

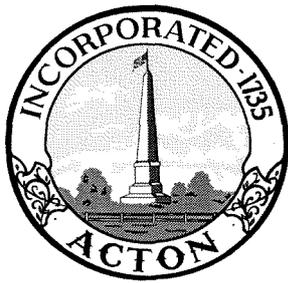
I do hope that you will support House 3584, and I sincerely appreciate your consideration of my testimony. I will be most happy to answer your questions.

Thank You.

William H. “Trey” Shupert, III
Member, Acton Board of Selectmen

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Testimony concerning Middlesex Reform Legislation **Additional Written Comments not provided in Oral Testimony**

Middlesex Retirement Board Reform Legislation -- House No. 3584 (2003)

Thursday, December 11, 2003

The Board of Selectmen of the Town of Acton strongly supports House No. 3584 (2003), proposed reform legislation regarding the composition, duties and responsibilities of the Middlesex Retirement Board ("MRB"). The Board of Selectmen respectfully requests that the Great and General Court pass this much-needed reform legislation as soon as possible to protect the retirement funds of present and retired public employees (and their contributing employers such as the Town of Acton) throughout the former Middlesex County.

In particular, the Board of Selectmen is extremely concerned about the significant financial losses to the Middlesex Retirement System ("MRS") allegedly resulting from a risky and speculative foreign currency investment strategy that the MRB engaged in over the course of several years. This foreign currency investment strategy, which put at grave risk, millions of dollars of hard-earned public employee retirement funds, allegedly involved possible breaches of applicable regulations and fiduciary duties.

In addition, the Board of Selectmen is concerned that MRB's acquisition and disposition of real property in Billerica through a limited liability company may have violated the letter or spirit of applicable PERAC regulations and public bidding laws.

Only a fundamental change to the way MRB does business can restore public confidence in the Middlesex Retirement System and help to prevent situations like this from recurring.

I. The Current Framework of the Public Employee Retirement System

The MRS is a public employee contributory retirement system, governed by G.L. c. 34B, § 19, and G.L. c. 32, § 1, et seq. Originally administered as an entity of Middlesex County, the MRS is one of 106 public pension systems in the Commonwealth, regulated by the Public Employee Retirement Administration Commission ("PERAC").

The public employee members of the Middlesex Retirement System must make regular contributions, typically through payroll deductions. G.L. c. 33, § 22. Their employers also make annual appropriations to the system, the amount of which is determined annually by the retirement

system's actuary, who determines how much the retirement system will need to spend on benefits over the course of a fiscal year. Public employers that belong to the system must appropriate and make payments to the system as required by the retirement board, and have no meaningful discretion to withhold such payments.' These funds comprise a sacred form of public trust, deserving the most professional, prudent and careful management and investment.

The MRB is responsible for the executive management of the retirement system, the collection of contributions from public employees and their employers, and the distribution of retirement and disability benefits. The scope of MRB's authority to perform these functions is presently limited by Chapter 32 and PERAC regulations.

Under PERAC's supervision, the MRB has the authority to invest the funds that the MRB holds in trust for the member public employees. MRB's retention of investment managers and consultants and the development of investment strategies is regulated by Chapter 32 and PERAC regulations. The MRB may only delegate responsibility for investing retirement system funds to a PERAC-approved "qualified investment manager," subject to a PERAC "exemption" from the investment restrictions set forth in G.L. c. 32, §23(2)(b)(i) through (vii), and selected based on a specified deliberative process. See, 840 CMR §§16.02, 19.01, *et. seq.*

In addition to the investment restrictions under G.L. c. 32, § 23, the MRB is prohibited by law from engaging in certain investments including, without limitation (840 CMR §21.01, emphasis added):

21.01: **Prohibited Investments**

No investment by any board or by any bank pooled fund, mutual fund, group trust, limited partnership, insurance company separate account or other form of pooled investment of any board **shall consist of any of the following:**

- (1) Purchases of securities by partial payment of their cost (purchases on margin).
- (2) Sale of securities not owned by the system at the time of sale (short sales).
- (3) **Future contracts other than as follows:**

(a) Forward currency contracts may be written against securities in the international portfolio by an investment advisor registered under the Investment Advisors Act of 1940 and who has been the subject of an exemption for international investment.

(b) Forward currency contracts may be written against securities in an international portfolio to a maximum 25% of the international portfolio non-dollar holdings at market value. Speculative currency positions unrelated to underlying portfolio holdings are strictly prohibited.

¹ See, Everett Retirement Bd. v. Board of Assessors of Everett, 19 Mass.App.Ct. 305, 308 (1985). For a discussion on the financing of retirement systems, see County Commrs. of Norfolk County v. Norfolk County Retirement System, 377 Mass. 696 (1979) and Massachusetts Retirement Law: A Primer, by Sandor Zapolin, Deputy Counsel of PERAC, <http://www.state.ma.us/perac/newlaw/ZapolinArticle.pdf>.

(4) Call options written against securities in the portfolio other than as follows:

(a) Call options may be written against equity securities (excluding international equities) in the portfolio by a qualified investment adviser registered under the Investment Advisers Act of 1940.

(b) Call options may be written against equity securities (excluding international equities) in the portfolio to a maximum of 25% of the market value of the equity portfolio (excluding international equities).

(c) Only options listed on a U.S. registered exchange may be written.

(5) Purchases of options other than as required to close out options positions.

(6) Lettered or restricted stock (with the exception of those investments that are venture capital investments).

(7) Direct investment in mortgages.

(8) Collateral loans (with the exception of those investments that are leveraged buyout investments), provided, however that boards may participate in so-called "securities lending" programs through a custodian and provided, further, that the lending of securities is limited to brokers, dealers, and financial institutions and that the loan is collateralized by cash or United States Government securities according to applicable regulatory requirements.

(9) Loans to employees or individuals.

(10) Direct purchase or lease of real estate.

Notably, to hedge against fluctuations of the value of the U.S. dollar, which could diminish or eviscerate gains in foreign equities that may exist in a board's investment portfolio, boards may, under § 21.01, enter into forward currency contracts, but only up to 25% of the market value of the foreign equities in its portfolio. However, a board **shall not** purchase options, or invest in options, as a means of hedging against such fluctuations in the value of the dollar. Moreover, "[s]peculative currency positions unrelated to underlying portfolio holdings are **strictly prohibited.**" Further, MRB is prohibited from using system funds to make a direct purchase or lease of real estate as an investment vehicle.

II. Allegations Concerning MRB's Foreign Currency Investment Strategy

On October 15, 1998, MRB entered into an Investment Management Agreement with Cambridge Financial Management, Inc. ("CF"), through which MRB authorized CF to invest a portion of the MRS investment portfolio, which currently has a value of around \$500 million, in a so-called "hedge program." Specifically, MRB retained CF to "buy and sell futures and option contracts in foreign currencies." See, Agreement, § 1. According to the Agreement, CF was given \$48 million to invest in the hedge program.

Under the Agreement, CF allegedly invested MRS funds in a variety of foreign currency options contracts. CF reportedly used two brokerage firms to handle trades on its behalf, Mellon Bank Capital Markets Group (“Mellon Brokerage”) and Goldman Sachs. At this time, MRS had apparently retained Mellon Financial/Boston Safe Deposit Company as its custodian bank reportedly responsible for providing MRS with regular financial statement, indicating the value of MRS’s various holdings, including the investments being managed by CF. According to a Complaint filed by MRS against Mellon Financial by MRS in Middlesex Superior Court on July 10, 2003, MRB was informed on April 30, 2003, that it had a “short exposure” during the months of February, March, and April 2003 of over \$19 million due to unfavorable option contracts that CF had entered into on behalf of MRB. MRB reportedly subsequently discovered that it had a short exposure on contracts with Mellon Brokerage equal to almost \$18 million,

It appears from the MRB Complaint, the Agreement and related information that CF allegedly purchased options, not currency contracts.² If this was in fact the case, CF - on MRB’s watch and under the MRB Agreement - may have violated PERAC’s strict prohibition on “[f]orward currency contracts [in excess of] . . . a maximum 25% of the international portfolio non-dollar holdings at market value” and/or on “[s]peculative currency positions unrelated to underlying portfolio holdings” which are “strictly prohibited.”

III. Potential Breach of Fiduciary Duty Predicated on Alleged Violations of Chapter 32 and PERAC Regulations Arising Out Of MRB’s Foreign Currency Investment Strategy

In their exercise of discretionary control over the management of retirement system funds, MRB’s members must conform to strict fiduciary standards under G.L. c. 32, § 23(3) and the PERAC regulations, 840 CMR §1.01.³ Specifically the MRB members must:

“discharge [their] 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.”

An MRB board member would be in breach of this fiduciary duty under § 1.02 of PERAC’s regulations for any of the following types of conduct:⁴

² A currency overlay strategy designed to hedge against foreign currency fluctuation could be propagated by either purchasing and trading options, or purchasing forward currency contracts.

³ Under Section 1 of Chapter 32, a “Fiduciary” means “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.”

⁴ Board member’s liability is limited by the following exception (840 CMR 1.04; emphasis added):

(1) Failure to comply with the fiduciary standard set forth in G.L. c. 32, § 23 and in 840 CMR §1.01 may subject the fiduciary to personal liability for any losses to the system resulting from such failure.

(2) If a fiduciary knowingly participates in or knowingly conceals an act or omission of a co-fiduciary which is a breach of fiduciary duty the fiduciary may be subject to personal liability for any losses to the system resulting from such breach.

(3) If, by failing to comply with his/her fiduciary duty, a fiduciary enables a co-fiduciary to breach his/her fiduciary duty, the fiduciary may be subject to personal liability for any losses to the system resulting from such breach.

(4) If a fiduciary has knowledge of a breach of fiduciary duty by a co-fiduciary and the fiduciary fails to make reasonable efforts under the circumstances to remedy the breach of fiduciary duty, the fiduciary may be subject to personal liability for any losses to the system resulting from such breach.⁵

Based on the above information, it appears that MRB authorized CF to engage in a “currency overlay” strategy to hedge against foreign currency fluctuations that could affect MRS’s holdings in foreign equities. The Board of Selectmen is concerned, however, that MRB crossed the line if and to the extent it authorized, directed or acquiesced in any purchase of currency options by CF, rather than strictly limiting the currency overlay strategy to *forward* currency contracts. Furthermore, the Agreement apparently authorized CF to invest up to \$48 million, which may have exceeded the 25% limitation on forward currency contracts set forth under PERAC regulations.⁶

As another cause for concern, MRB may have violated 840 CMR §16.02(5) when it executed an Agreement with CF that included a clause under which MRS agreed to hold CF harmless for “any act or omission in the course of, or connected with its performance under [the] Agreement.” Agreement, § 7. Section 16.02(5) provides that “no contract shall contain a provision which requires the indemnification of the manager by the retirement board.”

Members of a board which has received an exemption pursuant to 840 CMR 19.00 and has delegated investment discretion for assets to a qualified investment manager or is participating in or purchasing shares of the PRIT Fund shall not be liable for the acts or omissions of the qualified investment manager or of the PRIM Board, provided the selection and retention of such investment manager or of the PRIM Board is consistent with the members’ fiduciary duty.

⁵ The Superior Court has jurisdiction to restrain violations of Chapter 32 and PERAC regulations. Further, violations of Chapter 32 and PERAC regulations carry criminal penalties. G.L. c. 32, § 24(2).

⁶ Without knowing the exact value of MRS’s foreign equity portfolio, it is unlikely that the value was as high as \$192 million given that the entire system is valued at around \$525 million.

Such conduct may - if proven - rise to the level of a breach of the fiduciary duty imposed by Chapter 32, § 23(3) if MRB did not discharge its duties “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.” To the extent that both the “selection **and retention** of such investment manager [CF]” were not “consistent with the members’ fiduciary duty,” the MRB cannot avail itself of the protection of 840 CMR § 1.04 (emphasis added).⁷

IV. **MRB’s Acquisition of Investment Property in Billerica Through a Wholly Owned and Controlled Limited Liability Company Raises Additional Serious Concerns**

The Massachusetts Secretary of State’s database indicates that Middlesex Retirement System LLC, a Delaware LLC, was formed on 9/18/02 and registered in Massachusetts on 9/24/02, with a principal address at 25 Linnell Circle, Billerica. The resident agent for service is Attorney Thomas Gibson, with an address at 2400 Mass. Ave., Cambridge. The manager of the LLC is the Middlesex Retirement System.

The registration application filed with the Secretary of State states:

As of the date of formation, the Company is managed by its sole member, Middlesex Retirement System, a regional retirement system created pursuant to Chapter 34B, Section 19 of the Massachusetts General Laws.

The Deed from 25 Linnell Limited Partnership to “Middlesex Retirement System LLC, a Delaware LLC formed with an address of 25 Linnell Circle, Billerica” for the property at 25 Linnell Circle, Billerica, is dated 9/25/02 and recorded at Book 13684, Page 042. The Deed raises some serious questions:

- a. The Purchase Price was \$6,000,000. There is apparently no mortgage recorded with the deed, making it appear to have been a cash deal. This raises a serious question as to the source and use of the purchase money, as MRB was prohibited by PERAC regulations from using retirement system funds to make a direct purchase or lease of investment real estate.
- b. The LLC was formed on 9/18/02, registered in Massachusetts on 9/24/02, and closed on the purchase the next day. This quick timing suggests that there was a Purchase and Sale Agreement executed before the LLC was even formed, and that the LLC was the nominee of the Buyer under the P&S. Since the LLC was not in existence and the Middlesex Retirement System is the sole Member of the LLC, it is reasonable to infer that the likely Buyer on the P&S was the Middlesex Retirement System. In addition to PERAC’s prohibition on the use of retirement system funds to purchase investment real estate, an equally serious question arises as to whether the MRB failed to comply with Chapter 30B or other procurement laws in the acquisition of the property (and the subsequent rental to others of space in the

⁷ If the specific strategy pursued by MRB and CF was never approved by PERAC pursuant to 840 CMR §19.01 et seq., or if PERAC did not approve CF as a qualified investment manager, other potential violations of Chapter 32 or the regulations would exist.

property) by virtue of its creation and use of the wholly owned and controlled LLC vehicle.

Once again, such conduct - if proven - may rise to the level of a breach of the fiduciary duty imposed by Chapter 32, § 23(3).

V. Needed Revisions to the MRB Legislation

Whether or not the foregoing concerns would be borne out by a lengthy, expensive and time-consuming investigation of all the facts concerning the actions and omissions of the MRB, the mere possibility that there have been violations of PERAC regulations, breaches fiduciary duties, and circumvention of the public bidding laws provides a sufficient basis to restructure the composition, duties and responsibilities of the Middlesex Retirement Board. The Town of Acton is interested in ensuring that this situation is prevented from recurring in the future so that the retirement assets of the present and former employees of the Middlesex Retirement System are protected to the maximum extent possible.

In this context, House No. 3584 (2003), represents much-needed reform legislation regarding the composition, duties and responsibilities of the Middlesex Retirement Board. Briefly stated, the main features of the proposed legislation are as follows:

- **Replacement of Current Board Members**

Section 1 provides for the replacement of the current members of the Middlesex Retirement Board six months from the date of passage of the Act.

- **Appointment of Interim Executive Director**

Section 2 provides for the appointment of an interim Executive Director, the duties and responsibilities of which are created under Section 3.

- **Administration of the Retirement System**

Section 3 provides a comprehensive system for the administration and governance of the Middlesex Retirement System, including the election of members of the Retirement Board, and setting forth the duties and responsibilities of the Retirement Board, the Retirement Board Advisory Council (the "Advisory Council"), and the professional staff of the Retirement System. These provisions are designed to supplant the provisions of Chapter 32, Section 20 and Chapter 34B, Section 19.

- **Employment of Professional Staff**

Specifically, the Act calls for the appointment of an executive director, treasurer-custodian, and comptroller. Under the current system, the Chairman of the Retirement Board is the System's chief executive, and the Treasurer of the Retirement Board is the System's treasurer. As proposed, the comptroller would be responsible for providing an annual financial audit of the funds of the System, and the treasurer-custodian would have to "reconcile the total of all cash and investments in the custody of the treasurer-custodian with the fund balances maintained by the comptroller on a monthly basis." Section 3(c)(4).

- **Office Space**

Section 3(e) provides that any portions of real estate owned by the System that “exceed the current office space needs of the... system,... may be leased at market rates and the rent collected shall be deposited into the investment income account.” Further, the System “may only purchase real estate that is suitable for its office space, and may only purchase real estate that it can reasonably expect to fully occupy at some point in the future.”

- **Expansion of Advisory Council**

The Act provides for the expansion of the membership of the Advisory Council. Under the current system governed by G.L. c. 34B, §19, the Advisory Council is comprised of all of the treasurers of each governmental unit (cities, towns, districts, etc.) belonging to the Retirement System. The treasurers serve as their respective unit’s representatives. Under the Act, the treasurers remain members of the Advisory Council, but member governmental units with more than 100 participants must appoint a second representative to the Advisory Council. Section 3(g).

The responsibilities of the Advisory Council are also expanded under the Act. Annual estimates of administrative costs and expenses must be approved by the Advisory Council, after review and recommendations by a new “financial oversight committee” comprised of nine members of the Advisory Council. The Financial Oversight Committee (the “Committee”) also has the authority to review and make recommendations on the annual “final actuarial valuation report.” The treasurer-custodian must provide the Committee with quarterly reports on investment performance. The Committee may also make recommendations on investment policies and procedures to the Advisory Council.

Section 3(h) contains new provisions governing the maintenance of account balances from year to year.

- **Pension Liability Bonds**

Sections 3(n) - (t) authorize member units to issue “pension liability bonds” in order to raise money to finance all or a portion of the member unit’s accrued pension liability (the amount certified by the System’s actuary that the member unit must contribute towards its participating employees’ pensions each year).

VI. CONCLUSION

For the foregoing reasons, the Board of Selectmen respectfully requests that the Great and General Court pass this important and timely reform legislation as soon as possible to protect the retirement funds of present and retired public employees (and their contributing employers such as the Town of Acton) throughout the former Middlesex County.

The Acton Board of Selectmen