

**MINNEAPOLIS EMPLOYEES RETIREMENT FUND**

**SPECIAL REVIEW: OVERSIGHT BY MERF BOARD**

**AND STATE AUDITOR'S OFFICE**

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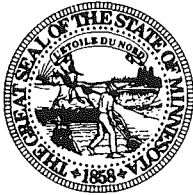
**MAY 1994**

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Financial Audit Division  
Office of the Legislative Auditor  
State of Minnesota

**94-20**





STATE OF MINNESOTA

**OFFICE OF THE LEGISLATIVE AUDITOR**

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Senator Phil Riveness, Chair  
Legislative Audit Commission

Members of the Legislative Audit Commission

## **Audit Scope**

We have conducted a special review of selected issues relating to oversight of the Minneapolis Employees Retirement Fund (MERF). The review was initiated at the direction of the Legislative Audit Commission which, on November 13, 1993, asked the Legislative Auditor to answer the following questions:

- During Mr. Chenoweth's tenure as Executive Director of MERF, did a member (or members) of the MERF Board of Directors have information indicating that an employee or board member of MERF might be involved in illegal or improper conduct related to his or her official duties. If so, what did the member (or members) do with the information?
- During Mr. Chenoweth's tenure as Executive Director of MERF, did the State Auditor's Office have information indicating that Mr. Chenoweth might be involved in illegal or improper conduct related to his duties as Executive Director? If so, what was done with the information?
- Did any auditor assigned to review MERF in 1988 or 1989 feel that his or her independence was impaired? If so, what was the cause and what did he or she do about it?
- How was the scope set for the State Auditor's 1988 and 1989 financial audits and its 1989 management study of MERF? Was the scope of any of those reviews restricted? If so, what was the cause of this restriction?
- What changes were made to the State Auditor's draft financial audit reports of MERF in 1988 and 1989 and to the 1989 draft management study report? Why were the changes made?
- What methods were used during the 1988 and 1989 audits to verify the value of MERF's material assets as reported on the financial statements? Specifically, how did the auditors determine that MERF had valued its real estate-related assets in compliance with the requirements of generally accepted accounting principles?

As directed by the Legislative Audit Commission, this review primarily focuses on MERF oversight in 1988 and 1989. However, to establish a context for our review, we expanded our scope to include selected information from prior and subsequent years.

## **Audit Techniques**

We reviewed reports and supporting Office of the State Auditor (OSA) working papers of MERF annual financial audits for 1987 through 1991, as well as the 1989 management study. We also reviewed former State Auditor Arne Carlson's files at the Minnesota Historical Society. We reviewed minutes of MERF board meetings for 1984 through 1992 and related board member and executive director files. We interviewed or took sworn testimony from 42 current and former employees, board members and representatives of the Office of the State Auditor and the Minneapolis Employees Retirement Fund. Appendix A identifies the individuals we contacted for this review. Appendix B provides a chronology of events relating to MERF and OSA, which took place during Mr. Chenoweth's tenure at MERF.

## **Conclusions**

In this report, we answer the questions asked by the Legislative Audit Commission. In addition, we provide additional analysis and interpretation of the underlying issues and concerns that prompted the questions.

The numerous problems experienced by MERF during the final years of John Chenoweth's tenure as executive director have been well-chronicled. Many witnesses described Mr. Chenoweth as a self-centered, egotistical person who was very moody. Most MERF employees avoided contact with him, though he rarely was in the office. MERF investments had begun to sour and a high incidence of "junk bonds" were discovered in the MERF portfolios shortly following Mr. Chenoweth's term as executive director. The prevalence of these problems brought into question the effectiveness of the oversight mechanisms that monitored MERF and its executive director. Our special review concentrated on two oversight mechanisms: The MERF board and the Office of the State Auditor. Another special study, being conducted by Mr. Allan Baumgartner, is reviewing oversight from the legislative perspective.

In Chapter 2, we answer the question about the reaction of the MERF board to any information indicating potential illegal or improper conduct. We found that the board took action when it became aware of such information. It failed, however, to prevent or to detect potential problems on a more timely basis. In particular, we found problems in three areas:

- The MERF board relied extensively on Mr. Chenoweth and board members were reluctant to contain his discretion or challenge his judgment. Also, in some matters, Mr. Chenoweth was not completely truthful or did not keep the board fully informed. This allowed certain improper activities to occur and inhibited the board's ability to exercise effective and timely oversight.

- The MERF board did not fully exercise the oversight responsibilities established in its investment policy.
- The MERF board did not prevent Mr. Chenoweth from creating personal conflicts of interest with companies in which it invested. It also allowed him to use his public position for personal gain.

We offer no recommendations for improvement in this report because we focused our review on activities in 1988 and 1989 and did not evaluate current practices. However, we think that lessons can be learned from the events at MERF in the late 1980's. If certain tools and techniques had been in place at MERF, some of the problems may have been avoided. It is possible that some of these changes have already been made. Regarding the MERF board, we think it would have been beneficial to have had:

- outside directors with management expertise to represent the state and the general public;
- independent advice on investments, possibly through an advisory committee of investment professionals;
- tighter guidelines for investing;
- a code of conduct for the board and staff, including a prohibition against the creation of potential conflicts of interest.
- an audit committee to review the annual financial audits and any special studies;
- a formal record of board proceedings and legal advice on resolutions and board actions; and
- annual performance appraisals of the executive director, including a method to evaluate management environment.

In addition, we think the board made a good decision in changing its basis for financial statement presentation in 1992. Market value reporting of investments provides more current information on the status of the fund's assets.

In Chapters 3-7, we answer the questions relating to the Office of the State Auditor. We found that OSA followed established office policies when investigating allegations and establishing audit scope at MERF. There was no evidence of an independence impairment that inhibited the office's ability to appropriately conduct MERF audits. We found no evidence that former State Auditor Carlson had a personal friendship or social relationship with Mr. Chenoweth or that he influenced the scope of MERF audits.

The Office of the State Auditor made numerous changes to its MERF draft reports during the review process. The auditors provided explanations of the reasons for various changes. We found no evidence that the changes were the result of a cover-up by the Office of the State Auditor.

However, we found problems in the following six areas:

- Differing expectations about the scope and objectives of the OSA management study created dissatisfaction with the final product.
- OSA did not consider MERF's financial affairs to be of broad public interest, and accordingly targeted its reports to a narrow primary audience.
- The style of the 1989 management study was distinctly different from a more adversarial style OSA used in several other reports it considered more high-profile.
- OSA auditors changed some report comments without adequately documenting the basis for the changes.
- OSA auditors did not identify and resolve differences of opinion within OSA regarding the resolution of tentative findings and recommendations (TFR).
- During 1988 and 1989, OSA auditors focused their work on investment carrying value. They did limited work to independently verify current value, particularly for nontraditional or alternative investments such as limited partnerships, mortgages, venture capital and real estate, which comprised 20 percent of the MERF investments.

Our special review revealed that the auditors could have done more to test the market value of MERF investments, particularly in the 1989 financial audit. In recent years, however, the auditing profession in general has learned the hard lesson about the need to verify the underlying value of assets. The savings and loan crises revealed how vulnerable auditors were in this area. As a result, the auditing profession has focused more attention on this aspect of an auditor's role in a financial statement audit.

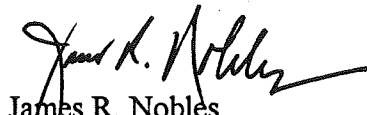
We also think this experience holds various lessons for the Office of the State Auditor, and all government auditors. First, it is important to manage reader expectations by:

- using consistent report tone;
- speaking to a broad public audience; and
- issuing timely reports.

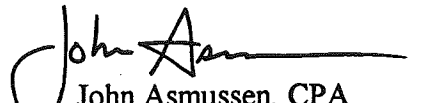
Also, auditors need to have thorough internal communications when developing and modifying report comments. To ensure accuracy and completeness, audit reports must be subjected to vigorous internal reviews. It is important to discuss and document:

- the reasons for changes to report drafts; and
- the resolution of professional differences of opinion between auditors.

This report is intended for the information of the Legislative Audit Commission. This restriction is not intended to limit the distribution of this report, which was released as a public document on May 9, 1994.



James R. Nobles  
Legislative Auditor



John Asmussen, CPA  
Deputy Legislative Auditor





## **Special Review: Minneapolis Employees Retirement Fund**

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### **Audit Participation**

The following members of the Office of the Legislative Auditor prepared this report:

John Asmussen, CPA	Deputy Legislative Auditor
Claudia Gudvangen, CPA	Audit Manager
Michael Hassing	Principal Auditor
Brad White, CPA	Principal Auditor
Mark Baloga	Attorney



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## Chapter 1. Introduction

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On August 29, 1993, the *Star Tribune*, a Minneapolis newspaper, published an article entitled "Overlooking the Books." The article sharply criticized former State Auditor Arne Carlson for allegedly failing to conduct proper oversight of the finances of the Minneapolis Employees Retirement Fund (MERF). Specifically, the article alleged that MERF and its former executive director, John Chenoweth, had undue influence over former State Auditor Carlson and his staff. It inferred that Mr. Chenoweth persuaded the State Auditor to slant reports so that the conclusions were favorable to MERF. The article also implied that State Auditor Carlson and his staff had knowledge of illegal and improper activities at MERF, and did not disclose them.

In response to this article, and other information provided by MERF's current executive director, James Hacking, the Legislative Audit Commission (LAC) held four hearings on MERF between September 24 and November 17, 1993. The LAC heard testimony from various individuals, including:

- Former State Senator Donald Moe, who chaired the Legislative Commission on Pensions and Retirement during part of the period when the Office of the State Auditor released the reports in question;
- Thomas Heffelfinger, a private attorney retained to represent Governor Arne Carlson on MERF issues;
- Elaine Hansen, who was director of audits in the Office of the State Auditor during most of the 1980's;
- Lawrence Martin and Edward Burek, Executive Director and Deputy Executive Director of the Legislative Commission on Pensions and Retirement;
- James Hacking, current Executive Director of MERF; and
- James Lind, current Chair of the MERF Board of Directors.

At the conclusion of testimony, the LAC directed the Legislative Auditor to conduct a review of MERF financial oversight by the MERF board and the Office of the State Auditor. The LAC asked six questions that are the focus of this review. Chapters 2 to 7 of this report provide our conclusions on these questions.

### Overview of MERF

MERF is a cost-sharing multiple employer pension plan. It is the largest local pension plan in Minnesota. The State Legislature established MERF in 1919 to provide members

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with survivor and disability protection during employment and financial security after retirement.

The following employer units currently participate in MERF:

- The City of Minneapolis
- Minneapolis Special School District #1
- City of Minneapolis Water Department
- Minneapolis/St. Paul Metropolitan Airports Commission
- Metropolitan Waste Control Commission
- Municipal Building Commission

MERF is a closed fund. Statutes restrict membership to employees hired prior to June 30, 1978. Those hired after that date are members of the statewide Public Employees Retirement Association (PERA). Table 1-1 shows MERF membership as of June 30, 1993.

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**Table 1-1**  
**MERF Membership**  
**June 30, 1993**

4,884	Retirees and beneficiaries receiving benefits
273	Terminated employees entitled to benefits but not yet receiving them
<u>2,321</u>	Current fully vested active employees
<u>7,478</u>	Total Participants

Source: MERF Annual Financial Report for fiscal year 1993.

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MERF receives funding from employee and employer contributions, as well as a contribution from the State of Minnesota. As required by Minnesota Statutes, employees contribute 9.75 percent of salary. The employer contribution, as established in statute, is based on annual actuarial calculations. It includes amounts for normal cost (that portion of the actuarial present value of pension plan benefits allocated to the valuation year), administrative expenses, and additional funding to be applied against the unfunded liability. Since 1979, the State of Minnesota has annually contributed an amount to amortize the unfunded actuarial accrued liability. In 1991, the Legislature limited the annual state contribution to \$10.455 million. In addition, the state funds certain lump sum payments for employees who retired prior to March 5, 1974.

Since 1973, Minn. Stat. Chapter 422A has governed MERF activities. The statute established four MERF funds. The deposit accumulation fund is used to accumulate assets for future benefit payments when current employees or their survivors become eligible for benefits. The disability benefit fund and the survivors benefit fund provide benefits to disabled employees and survivors of deceased employees, respectively. These three funds are commonly referred to collectively as the active fund. The retirement benefit fund, from which retiree benefits are paid, is the fourth fund.

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Minn. Stat. Section 422A also establishes a seven member retirement board that governs MERF activities. The board members are the sole trustees and custodians of MERF assets. The board appoints an executive director to administer MERF. Former State Senator John Chenoweth served as MERF executive director from November 1, 1979 to May 11, 1990. The board appointed James Hacking executive director on August 16, 1990.

Table 1-2 shows the MERF net assets available for benefits, at market value, as of June 30, 1993.

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**Table 1-2**  
**Minneapolis Employees Retirement Fund**  
**Net Assets Available for Benefits**  
**June 30, 1993**

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Investments, at market value:	
Short-term cash equivalents	\$ 90,736,962
Bonds	302,981,474
Common Stock	433,496,103
Mortgages	40,873,030
Limited Partnerships	24,658,224
Real Estate	22,046,140
Notes	<u>9,165,096</u>
Total Investments	<u>\$923,957,039</u>
Accounts Receivable and Accruals	23,887,991
Cash	<u>2,153,114</u>
 Total Assets	 <u>\$949,998,134</u>
 Total Liabilities	 <u>\$ 14,644,581</u>
 Net Assets Available For Benefits	 <u>\$935,353,553</u>

Source: MERF Annual Financial Report for Fiscal Year 1993.

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In 1981 the Legislature authorized MERF to withdraw its retirement benefit fund from the Minnesota Post Retirement Investment Fund, which is administered by the State Board of Investment (SBI). At the time of withdrawal, the MERF retirement benefit fund's net assets in the Post Retirement Fund were valued at over \$200 million. At June 30, 1993, the net assets attributable to the retired fund totaled \$656 million and the value attributable to the active fund totaled \$279 million.

MERF incurred significant losses on its investment portfolio in the late 1980's. Table 1-3 shows MERF investment balances, as reported in its financial statements, for fiscal years 1987 through 1991. Although the percentages vary, MERF invested a large portion of its assets in traditional stock and bond securities sold on the open market. It invested a smaller portion in mortgages, private placements, notes and limited partnerships, which were illiquid and had no ready market.

**Table 1-3**  
**MERF Investments**  
**June 30**

	1987	%	1988	%	1989	%	1990	%	1991 - Note 2	%
<b>Investments, at cost</b>										
Short Term Cash Equivalents	\$83,398,497	13%	\$112,638,534	16%	\$200,688,048	25%	\$152,967,867	18%	\$88,237,779	11%
Bonds	224,262,130	34%	201,759,919	28%	202,792,165	26%	226,143,613	27%	306,687,986	38%
Common Stock	202,053,576	31%	257,284,783	36%	238,939,829	30%	295,508,464	35%	286,535,951	36%
Mortgages	113,217,724	17%	106,771,783	15%	99,827,371	13%	90,965,349	11%	65,863,856	8%
Limited Partnerships	39,468,587	6%	44,911,501	6%	48,418,783	6%	47,791,491	6%	27,683,652	3%
Notes							17,476,291	2%	10,902,507	1%
Real Estate							7,310,255	1%	17,746,697	2%
<b>Total Carrying Value</b>	<b>\$662,400,514</b>	<b>100%</b>	<b>\$723,366,520</b>	<b>100%</b>	<b>\$790,666,196</b>	<b>100%</b>	<b>\$838,163,330</b>	<b>100%</b>	<b>\$803,658,428</b>	<b>100%</b>
<b>Investments, at market value:</b>										
Short Term Cash Equivalents	\$83,398,497	11%	\$112,638,534	15%	\$200,688,048	25%	\$152,967,867	18%	\$88,237,779	11%
Bonds	222,800,158	30%	186,495,567	25%	187,939,740	23%	207,471,389	25%	293,515,091	37%
Common Stock	264,922,864	36%	280,221,041	38%	258,792,520	32%	303,999,187	37%	295,428,350	38%
Mortgages	119,612,833	16%	106,794,430	15%	105,913,145	13%	92,167,276	11%	60,296,702	8%
Limited Partnerships	41,470,813	6%	46,408,422	6%	48,487,635	6%	47,816,336	6%	24,527,574	3%
Notes - Note 1							17,476,291	2%	9,055,844	1%
Real Estate - Note 1							7,310,255	1%	11,878,635	2%
<b>Total Market Value</b>	<b>\$732,205,165</b>	<b>100%</b>	<b>\$732,557,994</b>	<b>100%</b>	<b>\$801,821,088</b>	<b>100%</b>	<b>\$829,208,601</b>	<b>100%</b>	<b>\$782,939,975</b>	<b>100%</b>

Note 1: In 1987 through 1989, notes were included with short term cash equivalents and real estate was included with limited partnerships.

Note 2: The carrying value shown for 1991 includes a write down of \$57,981,630.

Source: MERF annual audited financial statements.

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MERF balance sheets for 1987 and subsequent years clearly show that MERF had unrealized losses on its bond portfolio. In addition, the fiscal year 1990 financial statements provided the first disclosure of the illiquid nature and absence of readily ascertainable market values for certain other investments. In 1991, MERF wrote down the value of various investments by \$58 million when it determined their value was permanently impaired.

In 1989 the Legislature passed Minn. Stat. Chapter 356A, the Public Pension Fiduciary Responsibility Act. This law, which was effective June 2, 1989, required MERF and other pension funds to comply with specific fiduciary guidelines. Pension fund board members and executive directors must file an annual economic interest statement to disclose any potential conflict of interest. The law did not set numeric limitations on investments, but specified the nature of the fiduciary duty owed when making investment decisions. For example, plan members and taxpayers are owed a fiduciary duty, and no fiduciary may be involved in a decision that could result in personal gain.

According to the people to whom we spoke, John Chenoweth was very popular among MERF members while he was executive director. We were told that the MERF office and board received many calls and letters from fund members supporting Mr. Chenoweth even during the time he ended his tenure as executive director. Mr. Chenoweth was not popular with most MERF employees, however. Several employees reported that Mr. Chenoweth was difficult to work for, and would refuse to deal with office issues, belittling anyone who asked for his assistance. Many employees apparently tried to avoid contact with Mr. Chenoweth. However, we were also told that Mr. Chenoweth was rarely in the office.

### **Overview of the Office of the State Auditor**

Article V of the State Constitution established the Office of the State Auditor (OSA). Prior to 1973, the office provided accounting services and a preaudit function for state agencies. In 1973, the Legislature transferred many of the office's duties to the newly created Department of Finance. In addition, the Legislature eliminated the former Public Examiners Office and distributed its duties to the Office of the Legislative Auditor, which was created in the 1973 reorganization, and to the Office of the State Auditor. The Legislative Auditor was given responsibility for state agency audits and OSA was given responsibility for local government audits. Minn. Stat. Chapter 6, which governs OSA, does not give it express authority or responsibility for oversight of MERF. However, a 1959 Attorney General Opinion provided that the former Public Examiner had a duty to audit and oversee MERF because MERF is an adjunct of the City of Minneapolis, which the office had an express duty to audit. This responsibility and authority was transferred to the State Auditor in 1973.

The office is headed by the elected State Auditor. Arne Carlson served as State Auditor from January 1979 to December 1990. Mark Dayton has served in the position from January 1991 to present. The director of audits is primarily responsible for the audit process at OSA. Elaine Hansen held this position from May 1980 to August 1988, when she resigned and was replaced by Fred Boethin. He left the office in May 1991. The OSA

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central office staff involved in the audit process also includes division directors, legal counsel, investigative staff and a standards and procedures section. Individual audit crews include a field supervisor, who has general responsibility for planning and coordinating the audit and producing the audit reports.

The audit activities of the office are currently funded by General Fund appropriations. For fiscal year 1993, the office received an appropriation of \$6,725,000. Minn. Stat. Section 6.58 requires the State Auditor to collect fees to cover the total cost and expenses of audit examinations. The office currently deposits the fees as nondedicated receipts to the General Fund. In the 1980's, the office operated primarily on a revolving fund.



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## Chapter 2: Oversight by the MERF Board

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### *Chapter Conclusions*

*We identified four occasions during John Chenoweth's tenure as executive director when MERF board members obtained information indicating potentially illegal or improper conduct by Mr. Chenoweth. We also found that the board periodically became aware of financial problems with MERF's investments. The board learned of the problem investments in the routine course of pension fund business, and not in conjunction with any potential misconduct by Mr. Chenoweth. We identified no evidence that the MERF board obtained any information during Mr. Chenoweth's tenure that implicated any other MERF employees or board members in potential illegal or improper activities.*

*The MERF board took some action in response to all four incidents involving Mr. Chenoweth, but it reached mixed conclusions. In some cases, board members were critical of Mr. Chenoweth's actions. On other matters, the board found no basis to criticize him. Also, based on information presented by Mr. Chenoweth, the board addressed problems with its investments.*

*The MERF board, however, placed a great deal of reliance on John Chenoweth as its executive director. It allowed Mr. Chenoweth to acquire an extensive concentration of authority and to operate very independently. He combined his extensive authority and strong personality to dominate the MERF board. On certain matters, Mr. Chenoweth was not completely truthful or did not keep the board fully informed. As a result, it was difficult for the board to provide effective, timely oversight of MERF activities.*

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The MERF board consists of seven members, including the Mayor of Minneapolis or designee, a Minneapolis City Council member, and five members elected by the members' association. Historically, the elected board members have been MERF members without specific training or experience in investments or pension fund management. Minn. Stat. Section 422A.03 empowers the board and executive director to make regulations necessary for administration of the fund. The statutes require the board to meet monthly, select its own officers, and hire an executive director. During the time period we reviewed, the board delegated primary control for fund management to its executive director.

The board hired former State Senator John Chenoweth as executive director in 1979. In 1983 the board also gave him the title of chief investment officer. The board accepted Mr. Chenoweth's resignation on May 11, 1990. It appointed James Hacking as executive director on August 16, 1990.

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In this chapter, we discuss the board's reaction to potentially illegal or improper activities. We answer the following questions:

**During Mr. Chenoweth's tenure as Executive Director of MERF, did a member (or members) of the MERF Board of Directors have information indicating that an employee or board member of MERF might be involved in illegal or improper conduct related to his or her official duties? If so, what did the member (or members) do with the information?**

We defined illegal or improper conduct as violations of state or federal law or established board policies. We reviewed certain other instances when Mr. Chenoweth may have exercised questionable judgment. Also, because of the significance of fund investments, we reviewed the board's reaction to problem investments.

We reviewed only those illegal or improper activities that board members were likely to know about during Mr. Chenoweth's tenure. After his departure from MERF in 1990, other allegations of illegal or improper activities were brought forward. The MERF board and its new executive director investigated these other allegations and took actions as necessary. For example, three MERF employees were convicted of embezzling funds from its mortgage program. Also, MERF investigated an allegation that Mr. Chenoweth accepted illegal kickbacks from investors. MERF continues to address problems with some investments purchased during Mr. Chenoweth's tenure. When appropriate, it has initiated legal action against investees.

### **Finding 1:**

**The MERF board relied extensively on Mr. Chenoweth and board members were reluctant to contain his discretion or challenge his judgment. Also, in some matters, Mr. Chenoweth was not completely truthful or did not keep the board fully informed. This allowed certain improper activities to occur and inhibited the board's ability to exercise effective and timely oversight.**

During the 1980's, the MERF board relied heavily on former Executive Director John Chenoweth. For most of his tenure, Mr. Chenoweth served as both chief executive officer and chief investment officer. The board often based major decisions, particularly those related to investments, primarily on his advice. Mr. Chenoweth had strong support from MERF members, as a result of delivering significant benefit increases to retirees. Board members told us, however, that they began to lose trust in Mr. Chenoweth in 1987, when the "Jaguar incident" occurred. At about that same time, some new members joined the board and began questioning some fund activities.

Board members described their primary responsibilities as hiring and overseeing the executive director, authorizing investments, and establishing policy. Board minutes do not offer complete evidence on the board's actions during Mr. Chenoweth's tenure. However, based on our interviews, we learned that the board extended great discretion to Mr. Chenoweth for making important business decisions. We were told that Mr. Chenoweth had a strong, aggressive personality that made it difficult for board members to challenge him. He operated with extensive independence and many people we talked to thought that he dominated the board.

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Board members consistently stated that prior to accepting Mr. Chenoweth's resignation, they had no documented evidence indicating he had committed any illegal acts. They cited only one case when a MERF employee came forward with concerns about fund operations or potential misconduct. Later in this chapter, we review that case and three other instances when the board responded to questionable conduct by Mr. Chenoweth. First, however, we review the board's responsibilities for MERF investments.

### **Investment Policy**

The board has historically reviewed and approved major investment decisions. Since MERF board members did not possess in-depth investment expertise, they relied heavily on the investment recommendations made by the executive director. The board also relied on the executive director to provide accurate and meaningful investment performance data. The board assigned a portion of fund assets to external investment managers. The executive director managed the remainder. MERF staff were responsible to ensure proper accounting and financial reporting for investments.

The MERF board adopted an investment philosophy and policy in January 1983. It did not revise the policy until 1990. The policy specified certain investment practices for the board, both in making investment choices and in reviewing investment status. For example, the 1983 policy discusses the prudent person standard which Minn. Stat. Section 422A.05 imposes on investments. The following statements from the policy discuss the need for prudence:

- Prudence mandates that we use the utmost care, skill and diligence in making sound investment decisions;
- Prudence calls for investing fund assets in productive investments, not purely speculative ones which contribute nothing to the productive capacity of our economy;
- Prudence means we are charged with using our skills and abilities to fulfill our investment responsibilities. We must set investment objectives which are appropriate for the individual needs and characteristics of the active and retired plans; and.
- Finally, we must diligently monitor the actions and performance of both in-house and outside managers to ensure that they meet the objectives and guidelines established.

Table 2-1 shows the asset allocation guidelines or general policy limits established in the 1983 policy. Because of differing fund goals and objectives, the policy establishes different guidelines for the active and retired funds.

## Special Review: Minneapolis Employees Retirement Fund

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**Table 2-1**  
**Asset Allocation Guidelines**  
**1983 MERF Board Policy**

	<u>Active Fund</u>	<u>Retired Fund</u>
Short term	5 to 50%	5 to 50%
Fixed Income	10 to 60%	20 to 60%
Governments	0 to 30%*	0 to 50%
Corporates	0 to 30%*	0 to 30%
Mortgages	0 to 30%*	0 to 20%
Equities	20 to 75%	10 to 50%
Corporate stock	20 to 70%*	
Real Estate - Note 1	0 to 20% (1)	
Venture Capital - Note 1	0 to 3% (1)	

Source: January 1983 MERF Investment Policy. Its notes indicate: \* Percentages are of total portfolio. (1) Formal board approval.

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### **Finding 2:**

**The MERF board did not fully exercise the oversight responsibilities established in its investment policy.**

Board meeting minutes did not indicate that the board considered its investment policy when it approved individual investments. Some board members testified that they asked Mr. Chenoweth whether proposed investments complied with the policy, and were assured they did. However, board members also told us that, to a great extent, they relied on the recommendations of Mr. Chenoweth when deciding the propriety or prudence of investments. Board members cited few examples of investments recommended by Mr. Chenoweth that they had turned down. In addition, Mr. Chenoweth sometimes did not provide the board with the detailed financial information needed to evaluate potential investments.

The board's investment policy provided that the board's investment committee, in conjunction with the executive director, should continuously monitor investment markets. It further provided that the board would set periodic asset allocation targets and achieve the targets by reallocating the in-house funds. However, neither board meeting minutes nor board member testimony showed that the board monitored markets, set asset allocation targets, or reallocated in-house assets to comply with the policy.

Additionally, the board's policy mandated an annual review of the investment objectives and overall investment program, including consideration of options to reduce portfolio volatility and risk. Again, we found no evidence that the board conducted the annual reviews.

## **Special Review: Minneapolis Employees Retirement Fund**

By not adhering to its investment policy, the board ultimately assumed added risk in its portfolio. We identified the following examples of investments which we do not believe were consistent with the allocation guidelines of the policy:

- The retired fund held real estate and limited partnerships. The policy did not specifically provide for such investments in the retired fund. MERF acquired some real estate as a result of defaults on other debt investments.
- Retired fund mortgage investments exceeded the 20 percent limit in the policy.
- Active fund venture capital investments exceeded the 3 percent limit identified in the policy. However, reports provided to board members prior to 1990 included some misclassifications. As a result, venture capital was shown at less than 3 percent.

In addition, we noted the following two examples of actions which we think were not consistent with the due diligence provisions of the MERF investment policy:

- MERF extended its contract with the Adler & Shaykin leveraged buy-out fund in order to increase its investment from \$5.3 to \$8.4 million during fiscal year 1989. The board did not analyze the Adler & Shaykin portfolio or the general leveraged buy-out market when making this decision. MERF previously had initiated a lawsuit against Adler & Shaykin to recover distributions due it.
- MERF converted \$390,000 in Ultimap debentures to stock in December 1989. The retired fund owned half of this asset. The conversion sacrificed a steady interest income stream for potential capital appreciation and variable interest. It also contradicted the policy for the retired fund to acquire income yielding investments, with capital appreciation as a secondary goal.

The board's policy also stated that the board owes a fiduciary duty to both plan members and taxpayers, and must focus on the economic interests common to both. However, during the 1989 management study the board responded to the Office of the State Auditor that MERF owed a fiduciary duty only to its members "and to no one else and...while it may be our wish that the broader interests of the public be given additional attention, such is simply not the law."

### **Monitoring Investment Performance**

Board meeting minutes periodically cited poorly performing investments that needed close monitoring. The board, however, did not have a well-defined investment performance monitoring system. It relied primarily on Mr. Chenoweth for information. Some board members found the periodic investment performance reports they were provided to be confusing and difficult to interpret. Also, performance monitoring was difficult for the high-risk MERF investments that lacked a ready market value.

Mr. Chenoweth informed the board of certain investment problems. The board discussed troubled investments at investment subcommittee and regular board meetings. The board

## Special Review: Minneapolis Employees Retirement Fund

generally supported Mr. Chenoweth's recommendations on how to resolve the problem investments. In some cases, however, Mr. Chenoweth did not fully inform the board of his actions or disclose that he had personal investment holdings in some of the troubled companies. The following examples show how MERF reacted to some problem investments:

- MERF had an \$11.5 million investment in three related limited partnerships, InterCap Monitoring Funds I, II, and III. The funds stopped distributing income to the limited partners in December 1988. During the spring or summer of 1989, Mr. Chenoweth had an employee review InterCap's financial records. Mr. Chenoweth informed the board of the problems with this investment in September 1989. Legal counsel then attempted to negotiate a settlement for the unpaid distributions. In late 1990, the board initiated litigation to recover its investment. Because of the permanent impairment in value, however, the board wrote off the entire \$11.5 million investment on its 1991 financial statements.
- Beginning in February 1988, MERF made a series of loans to Aquaculture Technologies, Ltd. (ATL), a start-up company based in Louisiana. It also held \$1.7 million in ATL stock. In February 1989, Mr. Chenoweth had concerns about ATL's use of MERF funds and sent an employee to examine its financial records. Because ATL would not cooperate and provide adequate financial information, Mr. Chenoweth asked the board to discontinue further funding until the company cooperated. MERF representatives again visited ATL offices in May 1989. They found ATL's financial records to be a complete mess and feared that it was on the verge of bankruptcy. In September 1989, the board refused to release additional funds to ATL until it received current, audited financial statements from the company. In the spring and summer of 1990, the board discussed whether to release a \$2.1 million loan to ATL. The board was concerned about a threatened lawsuit against it by ATL for delaying the project. In August 1990, the board voted to loan ATL an additional \$800,000 in exchange for it dropping the potential lawsuit. The board was also concerned about protecting the collateral for its investment. The board continued to monitor its relationship with ATL at monthly board meetings in 1990. ATL subsequently defaulted on the loans and MERF initiated litigation to recover its investment. In October 1991, based on an independent appraisal, MERF wrote off its entire \$1.7 million in ATL stock and wrote its loans down from \$7.8 million to 3.4 million.

Following Mr. Chenoweth's resignation, MERF staff alerted the board to a large percentage of junk bonds in the fund. The board turned the portfolio over to one of its external investment managers, asking them to review the portfolio and sell inappropriate securities. Board members told us that this was the first indication they had that the fund held significant junk bonds.

Although we did not evaluate MERF's current investments, we know that MERF's investment structure changed substantially after the board hired new Executive Director James Hacking in August 1990. We also know that it provides more quantifiable measures of target investment mix and performance. Also, Mr. Hacking has completed an in depth review of all MERF investments. The 1990 financial statements disclosed anticipated future losses on high-risk troubled investments. In 1991, MERF obtained appraisals, and other financial documentation, for many of the troubled investments. As shown in Table 2-2, this information resulted in investment write downs of \$58 million on the 1991 financial statements.

## Special Review: Minneapolis Employees Retirement Fund

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**Table 2-2**  
**Permanently Impaired Investments Written Down**  
**June 30, 1991**

	<u>Total</u>	<u>Active Fund</u>	<u>Retired Fund</u>
Bonds	\$ 7,636,777	\$ 803,637	\$ 6,833,140
Stock	13,918,707	10,196,295	3,722,412
Mortgages	9,865,029	0	9,865,029
Limited Partnerships	19,453,465	16,419,899	3,033,566
Notes	<u>7,107,652</u>	<u>6,717,691</u>	<u>389,961</u>
Total	<u>\$57,981,630</u>	<u>\$34,137,522</u>	<u>\$23,844,108</u>

Source: 1991 MERF annual financial report.

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### **Allegations of Illegal or Inappropriate Conduct by Mr. Chenoweth**

In the remainder of this chapter, we discuss the four instances when board members were alerted to possible illegal or improper conduct by Mr. Chenoweth during his employment:

- allegations about drug use and favoritism;
- the Jaguar automobile purchase;
- potential conflicts of interest; and
- efforts to remove board members.

The board received only the first allegation from a MERF employee. MERF board members actually had limited contact with the employees. Few MERF employees attended board meetings, so it is not surprising that other employees did not complain to the board. Employees told us, however, that Mr. Chenoweth was a terrible manager and that the working environment at MERF was very poor. Thus, it is unfortunate that the board did not seek more insights and information from the MERF employees.

Our review includes an analysis of the board's reaction once it became aware of the four issues listed above. We found that the board took some action, but was often hampered by incomplete information. We think that in some instances, particularly related to the purchase of the Jaguar automobile and the conflict of interest issues, Mr. Chenoweth took advantage of the trust and independence extended to him by the board. At the same time, in some situations, the board did not clearly define its expectations of Mr. Chenoweth. Further, in some cases, Mr. Chenoweth was not completely truthful or did not keep the board fully informed.

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### Allegations About Drug Use and Favoritism

Former MERF employee James Schweitz raised the most serious allegations of potentially illegal or improper conduct. Mr. Schweitz served as an administrative assistant to Executive Director Chenoweth. His main duties included working with the real estate portfolio. In April 1988, Mr. Schweitz expressed several concerns about Mr. Chenoweth to board member James Lind. Mr. Schweitz said that he contacted Mr. Lind because he was one of the newest board members, and he appeared willing to question various actions at board meetings.

Mr. Schweitz told us that he had grown increasingly concerned about Mr. Chenoweth's management style and personal behavior. Finally, on April 29, 1988, Mr. Schweitz went to Mr. Lind's office to express his concerns. Mr. Lind agreed not to disclose that Mr. Schweitz was the source of the allegations. Although there are some conflicts in their testimony, the two agree that Mr. Schweitz voiced the following concerns at the meeting:

- Mr. Chenoweth was possibly using cocaine. Mr. Schweitz felt that his suspicions of drug use explained Mr. Chenoweth's erratic behavior and forgetfulness. In addition, a New York broker had contacted Mr. Schweitz to raise concerns about Mr. Chenoweth's behavior. Mr. Schweitz said, however, that he never actually saw Mr. Chenoweth use cocaine.
- Mr. Chenoweth possibly showed favoritism by maintaining a privileged arrangement for accepting investment offers from one individual.
- A potential conflict existed because two principals at the company that originated MERF mortgages wrote mortgages to themselves.

In testimony, Mr. Schweitz told us he had other concerns, particularly about the mortgage program and some MERF investments. It is unclear whether he discussed these specific concerns with Mr. Lind. In addition, Mr. Schweitz testified that he once saw some evidence of drug use at Mr. Chenoweth's home (white powder and a razor blade on a mirror). Mr. Lind does not recall Mr. Schweitz discussing this specific evidence at the April meeting. He recalls that at a subsequent meeting in December 1988, Mr. Schweitz brought forward another MERF employee who mentioned seeing the evidence of drug use.

Immediately following the meeting with Mr. Schweitz, Mr. Lind contacted MERF legal counsel Donald Willeke for advice. Mr. Willeke guessed that Mr. Schweitz was the source of the allegations because Mr. Chenoweth had identified Mr. Schweitz as a disgruntled employee. Mr. Lind did not, however, acknowledge the source of the allegations to Mr. Willeke. Mr. Lind told us that Mr. Willeke advised him that, without specific evidence, the allegations could not be proved. Mr. Willeke expressed surprise about the cocaine allegations, however. He had accompanied Mr. Chenoweth on extended business trips and not seen evidence of drug use. Mr. Lind said that Mr. Willeke suggested he continue to monitor the situation.

Mr. Lind told us that, after talking to Mr. Willeke, he informed board members Harris, Johansen, and Johns about the allegations. He continued to protect Mr. Schweitz's identity. The board members were concerned about the allegations, but felt further proof was needed. They also believed that the State Auditor's management study, and related portfolio analysis, would disclose



## Special Review: Minneapolis Employees Retirement Fund

any problems with the mortgage program or other investments. The board members were also reassured because the management study and a consultant's personnel study were examining the working environment at MERF. Finally, Mr. Lind noted that no other MERF employees had expressed concerns about working for Mr. Chenoweth. He admitted, however, that the board members did not attempt to obtain concerns from other MERF employees.

Mr. Lind met again with Mr. Schweitz on August 6, 1988. They discussed essentially the same issues as at the previous meeting, and Mr. Schweitz was unable to produce further evidence. Subsequently, in December 1988, Mr. Schweitz convinced another MERF employee to corroborate the allegations. Mr. Schweitz brought the other employee to Mr. Lind's home one evening to discuss the concerns. At that time, Mr. Schweitz also agreed to talk to another board member.

According to Mr. Lind, on December 19, 1988, he and Mr. Schweitz met with board member Harris to discuss the allegations. After the meeting, it was decided that Mr. Harris, as Chair of the Personnel Committee, should notify the other board members about the allegations. Apparently, board member Lorna Hubert discussed the situation with Carole Schendel, secretary to Mr. Chenoweth. Ms. Schendel informed Mr. Chenoweth that Mr. Schweitz had made the allegations to the board.

Mr. Schweitz said that Mr. Chenoweth got extremely angry after hearing of the allegations. He told us that Mr. Chenoweth began to harass him and tried to get him to resign. He testified that Mr. Chenoweth revoked his parking privileges and took away his office. He was required to sign in and out of the MERF offices and had to sit at a card table in the hall.

The MERF Personnel Committee met on December 30, 1988. Board members Harris, Hubert, Johansen, Johns, and Lind, as well as Mr. Chenoweth, and legal counsel Willeke attended the meeting. It is unclear whether this was a formal board meeting, as there are no minutes. The allegation of drug use was the main topic at the meeting. According to Mr. Lind, Mr. Chenoweth went on the offensive, strongly denying that he had used cocaine. Mr. Harris offered to take Mr. Chenoweth for a blood test at an unspecified time in the future. Apparently, though, Mr. Chenoweth never took the blood test. Mr. Willeke reiterated his previous statement that he had never seen evidence of drug use when he had accompanied Mr. Chenoweth on extended business trips.

Although the board took no formal action, the members accepted Mr. Chenoweth's explanations. He apparently convinced the board that Mr. Schweitz was a disgruntled employee who did not have specific evidence of wrongdoing. Mr. Lind told us, however, that this incident convinced him the board should not renew Mr. Chenoweth's contract. His contract was due to expire in October 1989, and the board had to act on it by April 1989.

In January 1989, Mr. Chenoweth eliminated Mr. Schweitz's position. Mr. Lind said that Mr. Chenoweth told the board about the dismissal after it occurred. Mr. Schweitz subsequently filed a lawsuit against MERF. The parties settled the case with Mr. Schweitz receiving payment for his accrued leave balances.

## Special Review: Minneapolis Employees Retirement Fund

### The Jaguar Automobile Purchase

Most board members told us that they began to lose trust in Mr. Chenoweth after he purchased a Jaguar automobile with MERF funds in May 1987. Members believed Mr. Chenoweth acted inappropriately, and did not fully inform them of his intentions or actions. The board, however, had not clearly established its expectations when it authorized Mr. Chenoweth to purchase a vehicle. The board authorized the purchase without addressing issues related to vehicle type, ownership, and financing.

The MERF board provided Mr. Chenoweth with an automobile as part of his employment agreement. At its January 20, 1987, meeting, the board discussed replacing the existing vehicle, and approved the following resolution:

*The Fund will provide the Executive Director an automobile of his choice. If the cost exceeds \$15,900, the Executive Director will reimburse the Fund for the additional cost at the time of sale of the automobile.*

Although not formally documented as a part of the meeting, board member Willis Harris told us that he directed Mr. Chenoweth to buy an American made car.

Table 2-3 outlines the major events related to the Jaguar purchase.

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Table 2-3  
The Jaguar Automobile Purchase  
Major Events in 1987

<u>Date</u>	<u>Event</u>
January 20	MERF board authorized purchase of a vehicle
May 11	Mr. Chenoweth purchased Jaguar for \$41,817
June 13	Mr. Chenoweth had an accident with the Jaguar
June 30	<i>Star Tribune</i> published an article about the Jaguar purchase
July 6	Mr. Chenoweth repaid MERF \$26,187 for his share
July 10	MERF board met to discuss the issue
September 15	MERF board decided to sell the Jaguar
October 20	MERF sold Jaguar for \$40,000 and distributed proceeds

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Mr. Chenoweth purchased a 1988 4-door Jaguar sedan at a cost of \$41,817, plus \$202 for license fees. Mr. Chenoweth registered the vehicle title in MERF's name and paid for it with MERF funds. As a result, the purchase was tax exempt, and neither MERF nor Mr. Chenoweth paid sales tax on the transaction. In addition to the purchase price, MERF paid for insurance on the vehicle, as well as other related expenses.

In June, Mr. Chenoweth had an accident with the automobile. A few days later, City of Minneapolis officials received complaints about a Jaguar automobile emitting black smoke. After

## Special Review: Minneapolis Employees Retirement Fund

determining that MERF owned the vehicle, city officials contacted two board members, Walter Dziedzic and James Lind. The board members began to ask questions about the vehicle, and Mr. Dziedzic told a *Star Tribune* reporter about the issue. On June 30, 1987, the *Star Tribune* published an article about MERF's purchase of the Jaguar automobile. Press coverage continued for several days. In July, Mr. Chenoweth gave MERF a \$26,187 money order for his share of the purchase price, as shown in Table 2-4.

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Table 2-4  
The Jaguar Automobile Purchase  
Chenoweth Payment

Original purchase price	\$41,817
MERF authorized amount	<u>15,900</u>
Balance due from Mr. Chenoweth	\$25,917
Interest -- Note 1	<u>270</u>
Total Payment	<u>\$26,187</u>

Note 1: Interest on balance due for 55 days at 6.92 percent.

Note 2: Mr. Chenoweth apparently did not reimburse MERF for the increased cost of license fees and insurance.

Source: OSA working papers -- fiscal year 1987 financial audit.

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The MERF board held a special meeting in July 1987 to clarify action taken at its January 20, 1987, meeting. Board members Donald Fraser and Walter Dziedzic, who were not present at the January meeting, asked questions about cost, ownership, depreciation and financing of the vehicle. The board voted to ask legal counsel to review Mr. Chenoweth's employment contract regarding the use of a vehicle. It also asked legal counsel to examine the possibility of selling the automobile to the executive director and providing him with a car allowance.

In September, the board and Mr. Chenoweth agreed to sell the automobile and distribute the proceeds proportionately to each party. The board and Mr. Chenoweth entered into an agreement whereby the board would receive 38.03 percent of the sale proceeds, and Mr. Chenoweth would receive the remainder. The board further agreed that it would provide Mr. Chenoweth with a monthly car allowance. It based the monthly allowance on the lowest cost of leasing a \$15,900 car over 36 months. In October, MERF sold the automobile for \$40,000, and distributed the proceeds as provided in the agreement with Mr. Chenoweth.

We believe the MERF board took appropriate actions once it became aware that Mr. Chenoweth had purchased the Jaguar automobile. Members recognized that MERF ownership of a luxury vehicle would not be acceptable for a public agency. The public criticism about the purchase essentially forced the board into action.

The board also recognized that its January 1987 resolution failed to establish adequate control over the vehicle purchase. In effect, the resolution language allowed Mr. Chenoweth to obtain an interest-free loan. In an attempt to avoid additional problems or legal disputes on future decisions, the board requested its legal counsel to attend future board meetings.

## Special Review: Minneapolis Employees Retirement Fund

### Potential Conflicts of Interest

Mr. Chenoweth's personal involvement with companies in which MERF invested raised questions about potential conflicts of interest. The MERF board did not prevent Mr. Chenoweth from creating potential conflicts of interest with MERF investments. Mr. Chenoweth assumed unmitigated discretion for determining the appropriateness of his conduct related to companies in which MERF invested. During his employment at MERF, Mr. Chenoweth served as a voting board member for several companies in which MERF invested. The companies often compensated him for his service. In addition, Mr. Chenoweth invested his personal funds in several companies in which MERF also had significant investments.

#### Finding 3:

**The MERF board did not prevent Mr. Chenoweth from creating personal conflicts of interest with companies in which it invested. It also allowed him to use his public position for personal gain.**

The timing and level of board knowledge regarding Mr. Chenoweth's personal conflicts of interest are unclear. The board did not require Mr. Chenoweth to disclose activities or relationships that could create a conflict of interest. It was aware, however, that Mr. Chenoweth served as a director for some companies in which MERF invested. Also, the Office of the State Auditor's (OSA) 1989 management study disclosed seven such boards on which Mr. Chenoweth served (see Table 3-1 in Chapter 3). However, not until passage of the Public Pension Fiduciary Responsibility Act in 1989, were the executive director and board members subject to the public disclosure requirements of Minn. Stat. Chapter 10A.

The board members expressed to us a divided opinion on the propriety of Mr. Chenoweth serving on the boards of companies in which MERF invested. During Mr. Chenoweth's tenure as executive director of MERF, however, the board continued to respect a July 17, 1984 resolution that permitted the practice. Board members apparently concluded that the practice could be advantageous to MERF. Their resolution said:

*The Executive Director is authorized to participate in outside investment related activities where such participation, in his judgment, would be valuable to MERF and to accept the normal stipends for such service.*

Some board members told us they saw a benefit to MERF if the executive director served on boards of companies in which it held investments. These members told us about one instance where MERF, and other investors, gained as a result of this relationship. In that case, the investors obtained additional distributions from a leveraged buy-out fund, supposedly because of the efforts of Mr. Chenoweth, who served on the fund's advisory committee.

Other board members, particularly Mayor Fraser, told us that they were opposed to Mr. Chenoweth's service on boards. Mayor Fraser said he questioned the practice in late 1988. In December 1988, Mr. Chenoweth informed the MERF board that he was resigning from all advisory committees of investment partnerships. He complained about being criticized for serving on the private boards. The April 25, 1989, board meeting minutes reference Mr. Chenoweth's

## Special Review: Minneapolis Employees Retirement Fund

intention to resign from all boards. The MERF board, however, subsequently learned in early 1990 that Mr. Chenoweth still served on some of the boards, and had not resigned as he said he would. Also, Mr. Chenoweth discovered that OSA was examining a potential conflict involving Applied Vision Systems, Inc. (AVSI), where both MERF and Mr. Chenoweth had invested. At the March 20, 1990, MERF board meeting, Mr. Chenoweth disclosed that he held personal investments in AVSI and served on its board

The MERF board permitted Mr. Chenoweth to retain the additional compensation he earned for serving on these private boards. The OSA estimated in its 1989 management study that Mr. Chenoweth could have earned as much as \$19,000 in one year from serving on boards. The final management study report indicated that the MERF board subjected itself to additional legal exposure because it authorized Mr. Chenoweth to serve on the boards and to accept compensation.

We think it was not appropriate to allow Mr. Chenoweth to gain personally from his service on these boards. The MERF board allowed him to serve on the boards when it "would be valuable to MERF." In essence, it became part of his official duties. Therefore, at the very least, the income Mr. Chenoweth generated while fulfilling his duties to MERF, should have gone to MERF and not Mr. Chenoweth.

Some board members told us that they were also aware that Mr. Chenoweth had personal funds invested in the same companies or funds in which MERF invested, even though Mr. Chenoweth had publicly acknowledged that he had such investments. Mr. Chenoweth had, in fact, defended the practice by proclaiming "If the investment is good enough for me, it is good enough for MERF." Again, however, the board did not require Mr. Chenoweth to disclose the level of his investment in these companies, and he never provided the board with a complete list of the companies involved.

In addition to Mr. Chenoweth, one board member had a personal investment in a company in which MERF also invested. James Lind owned stock in Ultimap, Incorporated, as did Mr. Chenoweth and MERF. Both Mr. Lind and Mr. Chenoweth purchased their stock after MERF invested in the company. Mr. Lind disclosed his investment as required by the Public Pension Fiduciary Responsibility Act.

A Hennepin County employee noticed that both MERF and Mr. Chenoweth were shareholders in Ultimap. The employee was concerned that Mr. Chenoweth may have violated Minn. Stat. Section 471.88, which provides:

*a public officer who is authorized to take part in any manner in making any sale, lease, or contract in his official capacity shall not voluntarily have a personal financial interest in that sale, lease or contract or personally benefit financially therefrom. Every public officer who violates this provision is guilty of a gross misdemeanor.*

The official referred the issue to the Hennepin County Attorney. In April 1990, the Hennepin County Attorney's Office responded, but declined to pursue the issue further. The investigator found no indication of false representations or misrepresentations. In addition, the investigator

## **Special Review: Minneapolis Employees Retirement Fund**

found that Mr. Chenoweth's personal purchase of Ultimap stock occurred after the MERF purchase. Accordingly, the investigator concluded that he could not personally gain from MERF's participation in the company. The same conclusion would apply to Mr. Lind's investment.

As mentioned earlier, Mr. Chenoweth also had personal investments in AVSI. MERF owned both stock and short term notes of the company. The MERF loans occurred in 1988 and 1989 when the company was experiencing financial difficulties. MERF converted the short term notes to stock in October 1989. As executive director of MERF, as well as a member of the AVSI board, Mr. Chenoweth participated in the decisions to provide loans and later convert the debt investments to stock. This dual role raised conflict of interest questions. The conversion of MERF's debt investments to stock made it no longer superior to Mr. Chenoweth's personal holdings. In addition, MERF's continued funding of AVSI provided a potential benefit to Mr. Chenoweth by postponing losses on his personal investments.

Board members were generally not aware of Mr. Chenoweth's personal investments in AVSI until his disclosure at the March 1990 board meeting. The board was considering a tender offer for the company. The minutes state that because Mr. Chenoweth was a shareholder in the company, he suggested that AVSI make its recommendation directly to the board. Mr. Chenoweth also told the board that his investment was available for purchase by MERF at the same price as provided in the tender offer. Either way, however, Mr. Chenoweth stood to gain from MERF's AVSI investment.

It does not appear the MERF board ever considered the provisions of Minn. Stat. Section 471.88 as applicable to its activities. In addition, without complying with the statutory requirement, the board did not have a process to ensure that staff would not financially benefit personally from their actions as MERF employees. The disclosure requirements of Minn. Stat. Section 356A.06, effective June 2, 1989, provided a framework for improved controls.

### **Efforts to Remove Board Members**

Donald Willeke, MERF's legal counsel, told us that in early 1990 he became aware that Mr. Chenoweth was attempting to remove two members from the board. James Lind and Sharon Johns were among the least supportive members of Mr. Chenoweth. According to Mr. Willeke, Mr. Chenoweth intended to use the provisions of the new Public Pension Fiduciary Responsibility Act to oust these two members from the board. Mr. Chenoweth planned to assert that both Mr. Lind and Ms. Johns had a conflict of interest due to their mortgages through MERF's mortgage program. Mr. Willeke did not agree with Mr. Chenoweth's interpretation of the law. He noted that both members obtained their mortgages prior to joining the MERF board. He was also aware that Mr. Chenoweth had a mortgage through the MERF program. Nonetheless, Mr. Chenoweth intended to proceed with his plan.

Mr. Willeke felt it was his duty to inform the board members of his concerns. At the April 17, 1990, board meeting, Mr. Chenoweth raised his concerns about the board members having MERF mortgages. The board declined to take immediate action and directed legal counsel to research the issue further.

## **Special Review: Minneapolis Employees Retirement Fund**

By this time, Mr. Chenoweth's support from board members had eroded severely. He had previously submitted his resignation as executive director and had proposed to remain as chief investment officer, at his same salary. The board had begun a search for a new executive director and had intended that Mr. Chenoweth remain as executive director until it hired a replacement. However, in April 1990, Mr. Chenoweth forced the board to act when he announced his intentions to make some administrative changes within 30 days. At the regular meeting on May 11, 1990, the board refused to accept Mr. Chenoweth's employment proposal and ended its relationship with Mr. Chenoweth by accepting his resignation as both executive director and chief investment officer. According to a partial transcript of the meeting, Mr. Chenoweth was surprised by the board's decision and expressed his deep disappointment in individual board members.

## **Special Review: Minneapolis Employees Retirement Fund**

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## Chapter 3. Office of the State Auditor

### Knowledge of and Reaction to Illegal or Inappropriate Activities

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#### *Chapter Conclusions*

*During its audits of MERF, the Office of the State Auditor (OSA) obtained some information about potential improper activities by former MERF Executive Director Chenoweth. This information focused on Mr. Chenoweth's potential conflicts of interest with companies in which MERF invested and his decision to purchase the Jaguar automobile with MERF funds. OSA staff reviewed these matters in accordance with established office policies. However, the level of communication and reporting may have left some complainants with the impression that the auditor did not pursue an issue.*

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Like other audit offices, OSA obtains information on illegal or inappropriate activities in various ways. Tests of legal compliance may identify noncompliance with applicable laws, rules and regulations, or policies. Generally accepted governmental auditing standards require the auditors to review compliance with applicable laws and regulations as a part of all financial audits. In addition, while reviewing internal control, auditors may discover inappropriate practices. Auditors also sometimes obtain information on improper activities from auditee employees or outside parties.

According to former State Auditor Arne Carlson and former and current OSA staff we interviewed, when Mr. Carlson received allegations of impropriety, it was his practice to refer the information to either the office's director of audits or legal counsel. They were responsible to determine if the office would pursue an issue. If an audit was currently ongoing, the audit crew would normally investigate the issue. In those cases, the auditors would normally cite any problem areas in the management and compliance letter.

In this chapter we review the actions taken by the Office of the State Auditor relating to potentially illegal or improper activities at MERF. Specifically, we answer the following questions:

**During Mr. Chenoweth's tenure as Executive Director of MERF, did the State Auditor's Office have information indicating that Mr. Chenoweth might be involved in illegal or improper conduct related to his duties as Executive Director? If so, what was done with the information?**

We discuss two of the instances of potentially inappropriate activities that we reviewed in Chapter 2. In addition, some MERF employees testified that they informed OSA staff of concerns about investment valuation. We discuss those issues in Chapter 7.

## **Special Review: Minneapolis Employees Retirement Fund**

### **The Jaguar Automobile Purchase**

OSA first became aware of the Jaguar purchase when the *Star Tribune* publicly disclosed the issue on June 30, 1987. Current and former OSA employees remembered discussing the issue in the office. Former Director of Audits Elaine Hansen said that Mr. Carlson was incensed by the purchase. According to Ms. Hansen, Mr. Carlson felt the purchase showed very poor judgment and was a misuse of public funds. Former State Auditor Carlson told us, though, that he does not remember discussing this issue with Mr. Chenoweth.

OSA auditors reviewed the issue during the financial audit for fiscal year 1987. The field supervisor compiled information on the board authorization and the specific details of the vehicle purchase and subsequent sale. The field supervisor also wrote a memorandum to the municipal audit coordinator and OSA legal counsel asking whether the purchase would be subject to Minn. Stat. Section 471.345, Subd. 3, which requires sealed bids for contracts over \$15,000. In addition, the auditors obtained a prior Attorney General's opinion discussing the relationship of automobile allowances to statutory salary limitations.

The field supervisor and auditor in charge agreed that the purchase justified a comment in the management and compliance letter. The field supervisor developed a written comment on the issue. The comment provided background information on the transaction and questioned the specificity of the board's authorizing resolution. The comment concluded that the action taken by MERF in this purchase was inappropriate and weakened the members' confidence in MERF's management.

OSA management removed the Jaguar report comment from the 1987 management and compliance letter. It chose to present the comment in the 1989 management study instead. The 1987 management and compliance letter was not issued until December 1988, and the management study report draft was being finished at that time. We discuss the process and reasons for report revisions further in Chapter 6.

### **Potential Conflicts of Interest**

#### Service on boards and committees

In the 1989 management study, OSA addressed the executive director's service on boards of companies in which MERF invested. Former State Senator Donald Moe had included questions about the practice in a list of issues that he felt the management study should address.

The management study identified seven companies or funds for which Mr. Chenoweth served on advisory committees or boards of directors. It also identified any compensation Mr. Chenoweth received for such service. Table 3-1 identifies the former executive director's involvement with outside investment-related organizations, as reported in the OSA management study. The report raised some concerns about the potential for conflict of interest as a result of these arrangements. We discuss development of the management study report in Chapter 6.

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**Table 3-1**  
**Executive Director Chenoweth's Service on Boards and Committees**  
**As Reported by the Office of the State Auditor**

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<u>Entity</u>	<u>Compensation</u>
Adler and Shaykin Management Leveraged Buy-Out Fund Advisory Committee	\$2,500 annual meeting fee
Cherry Tree Venture Capital Advisory Board	No compensation
Dougery, Jones and Wilder Venture Capital Fund Investment Advisory Committee	\$1,000 quarterly meeting fee
GRI Corporation Board of Directors	\$3,350 annual meeting fee
Minnesota Seed Capital Fund Board of Directors (Advisory Committee)	No compensation
Polymer Composit Corporation Board of Directors	No compensation
Regent Security Partners Limited Partnership Advisory Committee	\$5,000 annual meeting fee

Source: 1989 OSA Management Study Report, pages 27 and 28.

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As a part of its review of outside service, OSA also addressed the issue of accepting payment for speaking engagements. Mr. Chenoweth represented to the auditors that groups only reimbursed him for expenses.

### Personal Investments

MERF employee James Cullen testified that, in the summer of 1989, he offered to provide evidence regarding Mr. Chenoweth's personal investments to Kurt Fritsch, an OSA auditor. The discussion took place after work in a Minneapolis bar. Mr. Cullen had performed some personal tax work for Mr. Chenoweth and possessed a listing of Mr. Chenoweth's personal investments. Mr. Cullen had noted that Mr. Chenoweth was investing in some of the same companies as MERF. Mr. Cullen testified that Mr. Fritsch did not want to look at the information. According to Mr. Cullen, Mr. Fritsch said there was nothing he could do about it.

Mr. Fritsch recalled this discussion. He stated that he did not want to see personal tax documents, because he considered them to be confidential. During the same audit, OSA and Mr. Fritsch received other information about Mr. Chenoweth's personal investments, as discussed in the next section. The auditors reviewed that information and developed report comments on the issue.

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### Applied Vision Systems, Inc.

On July 17, 1989, Winona City Manager Eric Sorenson, wrote to State Auditor Carlson with concerns about MERF. Mr. Sorenson included a prospectus for Applied Vision Systems, Inc. He expressed concern because he thought the prospectus showed that both MERF and Mr. Chenoweth owned significant shares of the company's stock. Mr. Sorenson's analysis showed that MERF owned 19 percent and Mr. Chenoweth owned 19.3 percent of the company's stock. In addition, he noted that MERF had provided the company with unsecured financing for several years. Mr. Sorenson expressed concern about the speculative nature and risk associated with these investments. While not alleging impropriety, he suggested that the information may warrant a review of the fund's investments and policies.

Former State Auditor Carlson does not specifically recall Mr. Sorenson's letter. He told us that he would have turned the letter over to legal counsel for review. The working papers for the fiscal year 1989 financial audit indicate that, in August 1989, Greg Hierlinger, Municipal Audit Coordinator, forwarded the letter to Kurt Fritsch, MERF field supervisor, for review. On September 15, 1989, OSA Legal Counsel David Kenney wrote to the mayor of Winona and informed him that auditors were following up on the issues during the current audit. Mr. Kenney also promised to send a copy of the final audit report to the mayor.

The working papers for the 1989 financial audit did not include a well-documented summary of the work done on the Applied Vision issue. It appears, however, that the auditors did the following:

- Reviewed the 1987, 1988, and 1989 board minutes for authorization of the Applied Vision acquisition. The working papers note that there was no reference to the acquisition in the minutes.
- Reviewed the Applied Vision prospectus. Auditors made notations and highlighted certain sections relating to MERF and Mr. Chenoweth and to the company's financial losses.
- Analyzed the relative holdings of MERF and Mr. Chenoweth, and how they acquired their shares. Mr. Fritsch concluded that Mr. Chenoweth's personal holdings in Applied Vision were significantly less than alleged. Rather than 1,543,342 shares, Mr. Fritsch found Mr. Chenoweth held 24,923 shares of stock. Mr. Fritsch determined that MERF and Mr. Chenoweth together held 19.3 percent of the stock. Mr. Sorenson had based his original analysis on some confusing information in the prospectus that inferred Mr. Chenoweth himself held 19.3 percent.
- Reviewed loan documents and other correspondence regarding the conversion of MERF loans to stock. Two of the notes, totaling \$300,000 were delinquent at the time they were converted to stock.

As described in Chapter 2, Mr. Chenoweth discussed his service as a director and his personal investments in Applied Vision at the March 20, 1990, board meeting. The next day, Greg Hierlinger, OSA Municipal Audit Coordinator, sent a letter to all board members asking them when and how they became aware of Mr. Chenoweth's personal investment in Applied Vision. Three of the four members who responded said that they were not aware of the investment prior

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to the board meeting. The fourth, Mayor Fraser, said that he heard about the holdings a few months prior, when he received an inquiry from another source.

Mr. Hierlinger also gave the board members a copy of the 1989 draft audit report with the March 21 letter. The draft report included a finding addressing concerns about Mr. Chenoweth's potential conflict of interest regarding Applied Vision. The draft finding suggested that MERF's continued investment in Applied Vision played an important role in helping to maintain Applied Vision's financial liquidity. The auditors stated that they believed the loan transactions allowed the executive director to personally profit as a result of the MERF investment. The auditors concluded that this violated Mr. Chenoweth's fiduciary duties under Minn. Stat. Section 356A.06, Subd. 3. We discuss subsequent revisions to this draft report in Chapter 6.

When OSA issued the final management letter for 1989, it sent a copy of the report to the Mayor of Winona. Mr. Fritsch testified to us that he should have sent the report to Mr. Sorenson, the Winona City Manager, since he initiated the inquiry. The final report comments did not include the detailed analysis of the Applied Vision issue or the conclusions on violation of fiduciary duties. OSA staff did not further correspond with Mr. Sorenson to explain their conclusions on the issues raised. Also, the final edited version of the report deleted specific details of Mr. Chenoweth's personal holding. As a result, Mr. Sorenson was not informed that some of his original analysis was flawed. Thus, he may have been left with the impression that the auditors did not pursue the issue adequately.

### Ultimap, Incorporated

During the fiscal year 1990 audit, the auditors became aware that the Hennepin County Attorney's Office had investigated whether Mr. Chenoweth may have been in violation of Minn. Stat. Section 471.87 relating to a public officer's interest in a contract. The question occurred because the Hennepin County Attorney was informed that Mr. Chenoweth had personal investments in Ultimap, Incorporated, a company in which MERF also invested. The auditors discovered that Mr. Chenoweth had not disclosed his personal investments to the MERF board. In fact, Mr. Chenoweth had not filed a statement of economic interest as required by state law. Minn. Stat. Section 356A.06, which was effective June 2, 1989, provides that annually:

*Each member of the governing board of a covered pension plan and the chief administrative officer of the plan shall file with the plan a statement of economic interest.*

In the 1990 report, OSA developed a report comment that criticized Mr. Chenoweth's failure to disclose his Ultimap investments to the board.

### **Other Issues**

There is no direct evidence that staff from the OSA knew of the allegations of cocaine use by Mr. Chenoweth. Former MERF employee James Schweitz, who brought the allegations to the MERF board, told us he did not discuss any of his concerns with the auditors.

In addition, we found no evidence that the Office of State Auditor was aware of attempts by former Executive Director John Chenoweth to remove uncooperative board members.

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## Chapter 4. Office of the State Auditor - Independence Impairments

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### *Chapter Conclusions*

*We found no evidence that Office of the State Auditor (OSA) staff felt there was an independence impairment that inhibited their ability to appropriately conduct MERF audits. Some audit staff were aware of rumors that former State Auditor Carlson had a personal friendship with John Chenoweth. However, the evidence indicates that only a business or professional relationship existed between the two men. There is no direct evidence of a personal friendship or social relationship between them.*

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Independence is one of the most important standards applicable to financial audits. *Government Auditing Standards*, issued by the Comptroller General of the United States, discusses the need for independence in governmental audits. It says:

*In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.<sup>1</sup>*

Independence means the auditor must be without bias with respect to the auditee. In its discussion of independence, *Government Auditing Standards* provides the following examples of potential personal impairments:<sup>2</sup>

- official, professional, personal, or financial relationships that might cause the auditor to limit the extent of the inquiry, to limit disclosure, or to weaken or slant audit findings in any way;
- preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit;
- previous responsibility for decision-making or managing an entity that would affect current operations of the entity or program being audited;
- biases, including those induced by political or social convictions, that result from employment in, or loyalty to, a particular group, organization, or level of government;

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<sup>1</sup>*Government Auditing Standards*, United States General Accounting Office, 1988, pages 3-4 and 3-5.

<sup>2</sup>*Government Auditing Standards*, United States General Accounting Office, 1988, pages 3-7 and 3-8.

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- subsequent performance of an audit by the same individual who, for example, had previously approved invoices, payrolls, claims, and other proposed payments of the entity or program being audited;
- concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records; and
- financial interest, direct or substantial indirect, in the audited entity or program.

An audit organization must establish policies and procedures to determine if auditors have any personal impairments.

In this chapter, we address OSA auditor independence and potential impairments. Specifically we answer the following questions:

**Did any auditor assigned to review MERF in 1988 or 1989 feel that his or her independence was impaired? If so, what was the cause and what did he or she do about it?**

For the time period we reviewed, the OSA policy on independence required all employees involved in the audit practice to disclose any conditions that impaired their independence in relation to a particular current or potential client. Staff annually filed an auditor independence statement. For the time covered by our review, the State Auditor, deputy state auditor and legal counsel did not file annual independence statements. We reviewed the independence statements for all staff assigned to MERF financial audits in 1988 and 1989. Staff did not disclose any independence impairments relating to MERF.

### **Alleged Friendship Between Arne Carlson and John Chenoweth**

There is no direct evidence of a personal relationship between former State Auditor Arne Carlson and John Chenoweth. Although there were rumors of a friendship, the auditors we interviewed said that their ability to appropriately conduct the MERF audits was not impaired. Some auditors, however, thought that Mr. Chenoweth had frequent discussions with Mr. Carlson about the MERF audits. On at least one occasion, an auditor speculated that an audit report was changed because Mr. Chenoweth had appealed to Mr. Carlson.

Mr. Carlson told us that he did not have a social relationship with Mr. Chenoweth. He stated that they worked together in the early 1980's because Mr. Carlson was studying the State Board of Investment's rate of return on investments. They met during that time to discuss various issues relating to investments. Mr. Carlson testified that he had limited contact with Mr. Chenoweth after this work on the State Investment Board.

Mr. Carlson's management staff described his relationship with Mr. Chenoweth in the late 1980's as professional, not social. Some OSA employees that had infrequent contact with Mr. Carlson



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told us they were uneasy about a rumored friendship. Apparently, Mr. Chenoweth was one source of the rumors. MERF staff told us that Mr. Chenoweth would comment that he and State Auditor Carlson were friends. At times when he had serious disagreements with auditors, he would reportedly say something like, "We'll just see what Arne has to say about this." The auditors assumed that Mr. Chenoweth would then call Mr. Carlson.

Mr. Carlson did not remember if he received calls from Mr. Chenoweth complaining about the audit work. Former Director of Audits Elaine Hansen stated that she discussed some calls with State Auditor Carlson, but that he never told her to change anything in an audit report. None of the auditors cited any instances when State Auditor Carlson told them to delete or alter any issues pertaining to MERF.

Ms. Hansen told us that there was only one instance when an auditor raised concerns to her about State Auditor Carlson's relationship with Mr. Chenoweth. Jerry Priess, who was the auditor in charge of the MERF audit in 1987 and 1988, told her that staff were concerned about the rumored friendship. Ms. Hansen told State Auditor Carlson about the concern. She testified to us that he was disappointed that a member of the audit staff thought he would compromise his independence and advised her that the auditors should treat Mr. Chenoweth the same as any other auditee. Mr. Carlson did not talk directly to Mr. Priess about this issue.

Mr. Priess told us that one reason for his concern was that he did not understand why the office made changes to the 1987 management and compliance letter. He speculated that the changes may have been the result of Mr. Chenoweth complaining to Mr. Carlson (see Chapter 6). He, and other auditors, testified that they discussed the rumors during MERF audits. Again, all staff said the issue did not affect their ability to appropriately conduct the audit. However, the perception of a possible impairment creates a troubling working environment for auditors.

### **Political Contributions**

During the early to mid-1980's, former State Auditor Carlson's campaign committees received contributions from the Minneapolis Municipal Retirement Association. The association is a separate legal entity from MERF, established pursuant to statutory authorization. Its membership includes active and retired members of MERF. One of its primary purposes is to elect members of the MERF board. In addition, it participates in lobbying on pension matters. The association is governed by a group of officers elected in accordance with its by-laws.

Disclosure reports for the Arne Carlson for State Auditor campaign committee, on file at the Ethical Practices Board, show contributions from the association of \$1,000 in 1981 and \$2,250 in 1982. In addition, the association's political committee disclosure reports for 1985 and 1986 show \$1,000 contributions to Arne Carlson in each year. Disclosure reports for 1987 through 1990 did not show any further contributions to State Auditor Carlson.

All of those we interviewed about the association said that there was no legal or administrative relationship between it and MERF. Former State Auditor Carlson testified that the political

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contributions he received from the association complied with applicable laws and did not create an independence problem.

We found no evidence to contradict this claim and no basis to conclude that the contributions from the Minneapolis Municipal Retirement Association to Mr. Carlson impaired his independence or that of the Office of State Auditor with respect to reviews of MERF.

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## Chapter 5. Office of the State Auditor - Audit Scope Restrictions

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### *Chapter Conclusions*

*Office of the State Auditor (OSA) staff followed normal office procedures in establishing the scope for the MERF annual financial audits. We found no evidence of any restrictions to the scope of these audits. Former State Auditor Carlson did not actively participate in the planning or fieldwork phases of the annual financial audits.*

*OSA followed a different process in establishing the scope for the 1989 management study. Former State Auditor Carlson participated in the decision to conduct the study and the preliminary planning meetings to determine scope. OSA restricted the study to a series of questions asked by former State Senator Donald Moe. It also chose not to answer some of Senator Moe's questions. Ultimately, differing expectations about the scope and objectives of the management study created dissatisfaction with the final product.*

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Establishment of audit scope and objectives is an important part of the audit planning process. In financial audits, auditors normally determine the scope based on the materiality and risk associated with the financial statement accounts. In describing the types of government audits, *Government Auditing Standards*, which establishes generally accepted governmental auditing standards, discusses the need to understand the audit objectives and scope. It says:

*The importance and comprehensive nature of government auditing places on government officials who authorize or arrange government audits the responsibility for providing audit coverage that is broad enough to help fulfill the reasonable needs of potential users of the audit report. This comprehensive nature of auditing also highlights the importance of the auditor having a clear understanding of the audit objectives, the scope of the work to be conducted and the reporting requirements.<sup>3</sup>*

In this section, we describe the Office of the State Auditor's process for determining audit scope and audit procedures. Specifically, we answer the following questions:

**How was the scope set for the State Auditor's 1988 and 1989 financial audits and its 1989 management study of MERF? Was the scope of any of those reviews restricted? If so, what was the cause of this restriction?**

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<sup>3</sup>*Government Auditing Standards*, United States General Accounting Office, 1988, page 2-5.

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The individuals involved and process followed in planning the financial audits differed from the management study. We will discuss each separately.

### **MERF Annual Financial Audits**

Central office senior management, including the State Auditor, had limited involvement in the planning and fieldwork phases of individual audits. They established general office guidelines for determining audit scope and audit procedures. They also trained staff on authoritative accounting and auditing literature. The office staff manual provided guidance on audit planning, fieldwork and reporting. OSA designed the audit scope and objectives for financial statement audits to comply with generally accepted government auditing standards.

The auditor in charge, or field supervisor, had primary responsibility for planning the individual MERF audits. Audit planning and identification of scope for MERF financial audits were fairly standard from year to year. For fiscal year 1988, auditors carried forward and updated a planning memorandum prepared in the prior year by the field supervisor. The memorandum provided an overview of MERF's organizational structure, funds and accounts, and the basic accounting system. In addition, it generally described the investment, cash receipt and disbursement processes, as well as annuitant and contribution recordkeeping. It also discussed reporting requirements and timing and staffing of the audit.

The memorandum identifies the following critical audit areas:

- investments;
- investment income;
- employer and employee contributions;
- state contributions; and
- benefits payroll.

In the update for 1988, the field supervisor added a description of the MERFCO mortgage servicing program to the discussion of investments. For each critical area, the auditor identified the basic audit approach and the type of testing anticipated.

For fiscal year 1989, the field supervisor again developed an audit planning memorandum. It was quite similar to the prior year's document, but added some information, resulting from changing audit standards. The memorandum identified the same critical audit areas as in the prior year.

In addition to the planning memorandum, the auditors developed an audit program with detailed procedures for each area. In our review of the audit working papers for 1988 and 1989, we found that the auditors generally complied with the approach described in the planning memorandum. In some cases, procedures or the approach were expanded or changed as a result of a

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preliminary review of the area. We further discuss the specific work completed on investments in Chapter 7.

We found no evidence of restrictions on the audit scope for these audits. Jerry Priess, who was the auditor in charge in 1988, said that he was never pressured by the office to modify the MERF audit scope. Similarly, other OSA auditors told us that OSA management had no involvement in fieldwork decisions. Actually, most staff said they had limited contact with Mr. Carlson during his tenure as State Auditor. In the central office, OSA held periodic management meetings. The director of audits and the division directors would inform Mr. Carlson of the status of audits at those meetings. Mr. Carlson told us that they would discuss any significant issues relating to ongoing audits.

We found only one instance in the working papers identifying former State Auditor Carlson's involvement in the fieldwork for a MERF audit. During the fiscal year 1989 audit, field supervisor Kurt Fritsch did an analysis of John Chenoweth's automobile claims. He calculated a \$565 average cost per month for Mr. Chenoweth's automobile allowance, insurance, parking, gasoline and miscellaneous expenses. As an example of criteria for the reasonableness of these expenditures, Mr. Fritsch included an article discussing a recent Office of the Legislative Auditor report on the Greater Minnesota Corporation (GMC). That report questioned similar costs, averaging \$720 per month, for the former GMC president. Mr. Fritsch wrote in the working papers: "I discussed this with State Auditor Arne Carlson. He stated that the majority of the expenses were reasonable and authorized by the board. Therefore, I was to drop the topic."

Neither former State Auditor Carlson nor Mr. Fritsch recalls the conversation, although Mr. Fritsch verified it was his writing on the working papers. Mr. Fritsch noted that the amount in question was less than the GMC amount. Therefore, he was not concerned about dropping the issue.

### **1989 Management Study**

In contrast to the financial audits, OSA management, including the State Auditor, participated in the initial planning for the 1989 management study. They attended various meetings with representatives of the MERF board, the city of Minneapolis, and the Legislative Commission on Pensions and Retirement, as well as former State Senator Donald Moe, who originally requested the study. The MERF board asked that the study include an expanded time period. In addition, the board wanted a detailed analysis of its investment portfolio. OSA management did not think it was qualified to evaluate investment performance, and they contracted with a professor at St. Thomas College to perform that analysis. The office issued two separate reports. We did not review the work conducted for the investment performance portion of the study.

OSA management selected Richard Pietrick to supervise the study. He had served as field supervisor for the MERF financial audits in the early 1980's. The office assigned other staff to assist Mr. Pietrick with the study. Mr. Pietrick told us that the study techniques included various interviews and analyses of data. In addition, OSA sent a questionnaire to MERF board members and staff. The study did not include significant testing of transactions, which normally occurs in a

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financial audit. The office did not design the study to comply with generally accepted auditing standards, because it was not considered an "audit."

Mr. Pietrick reported to the director of audits for the study. Elaine Hansen, who served in that position until August 1988, said she frequently met with Mr. Pietrick to discuss the project's status. She also had many discussions about the study with former State Auditor Carlson. According to Ms. Hansen, one of Mr. Carlson's main concerns was the timeliness of the study, because it took longer than originally anticipated to complete. When Ms. Hansen resigned, Fred Boethin assumed her duties. Mr. Boethin, however, played a limited role in overseeing the management study.

### **Finding 4.**

**Differing expectations about the scope and objectives of the OSA management study created dissatisfaction with the final product.**

The OSA final report did not satisfy many users. Some MERF board members told us that they thought the final report (as well as prior drafts) discussed a lot of small, picky issues. They had expected that the study would provide a better overall review of MERF management. In addition, Lawrence Martin and Edward Burek, staff of the Legislative Commission on Pensions and Retirement, reviewed the report for former Senator Moe. They concluded that the study was inappropriate in its scope. In a memorandum dated June 12, 1989, they stated that the study did not meet the customary view of a management study.

OSA based the study on a series of questions asked by Senator Moe in a letter dated November 6, 1987. Mr. Martin assisted in drafting the questions. The areas of inquiry included the following nine general areas:

- MERF administrative expenses;
- service by MERF officials on other boards;
- special services and benefits for MERF members;
- unusual member contributions and buybacks;
- role and function of the MERF Association
- compensation and employment benefits of MERF employees;
- MERF board and employee travel;
- transfers between deposit accumulation fund and retirement benefit fund; and
- investment transaction costs.

Each area included general and specific questions.

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The auditors limited their efforts to obtaining information to specifically answer Senator Moe's questions. However, the auditors did not provide information on certain specific questions raised by Senator Moe, including:

- providing various comparisons between MERF and other public pension plans; and
- comparing costs of each investment transaction to the least costly transaction arrangement available at the time of the transaction and the time elapsed between each transaction order and its actual execution.

In the report introduction, the auditors attempted to explain their reasons for not addressing these issues.

Mr. Pietrick told us that OSA did not add any additional issues to the study's scope. In the June 12, 1989 memorandum, Mr. Martin and Mr. Burek argued that the questions should have been merely a point of departure for a thorough review of MERF's structure and operations. We agree it is somewhat of a misnomer to refer to the report as a management study, because OSA did not do a comprehensive review of MERF's management structure. On the basis of its work, OSA probably more appropriately should have referred to the report as a special study of selected issues.

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## Chapter 6. Office of the State Auditor - Revisions to Report Drafts

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### *Chapter Conclusions*

*The Office of the State Auditor (OSA) made numerous changes to its MERF draft reports during the review process. In some cases, OSA management determined that staff conclusions were inappropriate based on the supporting documentation. In other instances, MERF representatives persuaded OSA that its conclusions were erroneous or its judgments were too harsh. In addition, because of the unusual situation of developing both annual audit reports and the management study at the same time, OSA decided to move comments from one report to another.*

*For the MERF reports, the auditors used a reporting style intended to present information that was primarily factual and avoided making subjective judgments. The auditors wrote these reports with a rather narrow target audience in mind. This style confused some report readers, because it was inconsistent with other high-profile reports produced by the office.*

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During the time period of our review, OSA staff developed initial report drafts in the field. The office used a form entitled "Tentative Finding and Recommendation" (TFR) to record concerns identified during audit testing. The office encouraged auditors to prepare TFRs as they encountered potential problem areas. The TFR identified the problem or condition, the criteria or what should be, the cause of the problem, its effect, and the recommendations for improvement.

The field supervisor had primary responsibility for preparing the draft report. Various OSA central office employees reviewed the draft report and supporting documentation for substance and style. Following the central office review, the auditee had an opportunity to review the draft report. OSA could make additional changes to the report based on the auditee's comments.

In this chapter, we discuss the development of MERF draft reports and specific changes made to the documents before OSA issued the final reports. We reviewed three annual financial audits and the management study. We answer the follow questions:

**What changes were made to the State Auditor's draft financial audit reports of MERF in 1987, 1988 and 1989 and to the 1989 draft management study report? Why were the changes made?**

Representatives of the Office of the State Auditor provided us with reasonable explanations for changes made to the MERF report drafts. However, the auditors used a report style, particularly

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for the management study, that surprised some observers because it avoided making judgments on MERF's fiscal practices. Also, we did not find adequate documentation in the working papers for some of the report changes; therefore, we had to establish the basis for those changes by interviewing the auditors. We conclude, though, that the auditors developed the 1987-1989 management letters within the parameters of generally accepted auditing standards. OSA did not consider the 1989 management study to be an audit, and accordingly felt it was not subject to the guidance of generally accepted auditing standards.

The *Star Tribune* article implied that the State Auditor's Office changed the report drafts to protect either Mr. Chenoweth or MERF from public criticism. We found no evidence that the changes were the result of a cover-up by the Office of the State Auditor. Furthermore, we did not find that the Office of the State Auditor failed to address problems that it identified during the audits and the management study.

### Inconsistent Reporting Styles

For the reports on MERF, the auditors ultimately adopted a reporting style intended to present information that was primarily factual and avoided making subjective judgments. The auditors wrote these reports with a rather narrow target audience in mind. Therefore, it chose not to adopt a more adversarial style for the reports, such as it used for high-profile reports like the Minnesota State High School League and the St. Paul Port Authority.

#### Finding 5:

**OSA did not consider MERF's financial affairs to be of broad public interest, and accordingly targeted its reports to a narrow primary audience.**

The Office of the State Auditor considered the MERF board to be its primary client for the 1987-1989 financial statement audits. For the 1989 management study, the State Auditor identified the primary target audience as a single legislator, Senator Donald Moe. We think these decisions had a profound effect on the report styles and contents. We think the reports would probably have been different in tone and maybe in substance if they had been written for a broader, public audience or the auditors had chosen to challenge the judgments of the MERF board.

On some issues, the auditors felt that eliminating information from the final report was inconsequential because the most important audience, the MERF board members, had already seen it in the original draft. We heard that argument, for example, regarding the decision to remove the comment on the delinquent Battle Creek Condominium Mortgages from the 1989 management and compliance letter. We think, however, that some issues the auditors omitted from the final reports would have been of interest to a broader, public audience.

Because OSA directed the 1989 management study primarily to Senator Donald Moe, the study report was written in a factual and informative format, and did not render subjective judgments. OSA justified this format based on a perception that a hostile relationship existed between

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Mr. Chenoweth and Senator Moe. The State Auditor's Office did not want the management study to be used as "ammunition in the battle between these two strong personalities."<sup>4</sup>

### **Finding 6:**

**The style of the 1989 management study was distinctly different from a more adversarial style the auditors used in other high-profile reports.**

The style of the auditor's reports on MERF offers a stark contrast to the more accusatory, judgmental style presented in other more high-profile audit reports, such as its reports on the Minnesota State High School League and the St. Paul Port Authority. Former State Auditor Carlson acknowledged to us that those reports were more aggressive than the MERF reports. Mr. Carlson justified the different tone by saying OSA had a broader target audience for those two audits. Those reports he told us, were aimed at "the general public, as a result of the press coverage and public complaint."<sup>5</sup>

Some report readers expressed confusion and frustration in interpreting and understanding the 1989 management study report. Those readers expected the report to be more confrontational and to render sharp criticisms of MERF's financial activities. The basis for those expectations, we believe, are the State Auditor's reports on the Minnesota State High School League and the St. Paul Port Authority. Table 6-1 compares selected report comments from those two audits to similar comments presented in the 1989 MERF management study. The comparison clearly shows the difference in report styles. It is also interesting to note how the media characterized the different reports. The 1989 MERF management study did not capture headlines; only a few newspaper articles mentioned it. One article referred to Mr. Chenoweth's description of the study as "an investigation that cost \$100,000 and turned up no wrongdoing."<sup>6</sup> (Note: The management study actually cost approximately \$65,000, including \$10,000 for the separate investment study.) Another article mentioned that "The May 1989 report found little wrong."<sup>7</sup> Conversely, newspaper articles described the audits of the High School League and St. Paul Port Authority as highly critical.

## **Documentation and Internal Communications for Report Changes**

Despite obtaining reasonable explanations for the report changes, we are concerned that the reasons often were not documented in the audit working papers. In several cases we had to obtain explanations by interviewing the auditors. We are also concerned that the working papers did not document some potential differences of opinion that the auditors may have had over resolution of certain matters. Communications in the OSA were not designed to identify whether auditors agreed with, or were even aware of, the final resolution of audit issues they had worked on.

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<sup>4</sup> March 11, 1994 letter from Mr. Thomas Heffelfinger, attorney for former State Auditor Arne Carlson.

<sup>5</sup> Ibid.

<sup>6</sup> *City Business*, August 7-20, 1989, "Pension Director Tires of Fighting City Hall" by Beth Ewen.

<sup>7</sup> *Minneapolis Star Tribune*, April 1, 1991, "Pension Fund Lawsuit Charges Chenoweth Hid Investing Risks", By Dennis J. McGrath and David Phelps.

## Special Review: Minneapolis Employees Retirement Fund

**Table 6-1**  
**Office of the State Auditor**  
**Comparison of Report Styles**

<u>State High School League</u> December 1987 and April 1989 reports	<u>St. Paul Port Authority</u> August, 1986 report	<u>MERF Management Study</u> May 1989 Report
<u>Cover Letter 12/87 report:</u> ...the pay scales were generous, the benefits extraordinary...and the financial accountability virtually nonexistent.	<u>Cover Letter Page.2:</u> [The Port] handles public money generously when it comes to entertainment and travel.	<u>Page 58:</u> "The Executive Director is not covered by Minneapolis City Civil Service regulations thus, the Retirement Board would appear to have wide discretion in establishing the terms and conditions of the Executive Director's employment, provided these terms and conditions are in compliance with relevant statutes.
<u>Page10 (12/87 report):</u> It is unheard of for a Public agency to furnish its entire executive staff with upscale automobiles...This may be very acceptable in the private sector when it is considered part of the employee compensation package, but not for a Public body.	<u>Page 18:</u> ...the Port Authority is in fact a governmental unit and should conduct itself as such... Employees of the Port Authority should not be allowed privileges not available to other governmental employees, based on a theory that the nature of their work is different.	<u>Page 87:</u> Senator Moe questioned whether any automobiles furnished the Executive Director, in accordance with his employment agreement, were appropriate for the use for which they were employed. Such a question is difficult to answer as it deals with the public's perception of the arrangements made. We are not in a position to determine the public's perception of the appropriateness of the automobile arrangements..
<u>Page 28 (4/89 Report):</u> "When this accountability is absent, it is inevitably the taxpayer who loses. It is clear that in this case the taxpayer has been made to pay and certain staff members have benefited from poor management practices which resulted in non-existent or lost records and improper expenditures of public funds."	<u>Page 10:</u> "We found a pattern of extravagance when the reimbursements are compared to those of other units of government, a virtual lack of statement as to the 'purpose of the expenditure' as required by the Port Authority's travel policy, and a general disregard for the substantiation requirements of unusual or excessive expenditures."	<u>Page19:</u> "It would appear that of the outlays for administration that were borne by the Active Account, if there is a greater share of these charged directly against fund earnings, then the State's financial liability...could be reduced, though probably not materially."

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### Finding 7:

**The auditors changed some report comments without adequately documenting the basis for the change.**

As our analysis of the 1987-1989 MERF management letters shows, the auditors deleted or modified some report comments without adequately explaining the changes in the working papers. Generally accepted auditing standards establish that:

*Working papers are the link between field work and the auditors' report. They serve as a record of the results of the audit and the basis of the auditors' opinions.<sup>8</sup>*

We were able to establish the reasons for the report changes only after interviewing the auditors. Auditing standards, however, state that the working papers should "contain sufficient information so that supplemental oral explanations are not required."<sup>9</sup> If the working papers had contained adequate documentation, the auditors could have avoided much of the suspicion about the motivations behind the report changes.

### Finding 8:

**The auditors did not identify and resolve any differences of opinion regarding the resolution of tentative findings and recommendations (TFR).**

A final audit report should represent a consensus professional judgment of the auditors associated with an audit engagement. The auditing standards recognize that professional persons may reach different opinions on some matters. In those cases, the auditing standards direct that the disagreement shall be documented in the working papers. Our interviews with the auditors revealed that staff auditors sometimes were not aware of how TFRs had been resolved, and in other cases disagreed with the final resolution. The working papers, however, disclosed a difference of opinion on only a couple of issues.

Generally accepted auditing standards require that auditors document any matters over which auditors may have differing opinions.

*The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his disagreement with the conclusions reached if, after appropriate consultation, he believes it necessary to disassociate himself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented.<sup>10</sup>*

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<sup>8</sup>Government Auditing Standards published by the United States General Accounting Office, page 4-6, paragraph 20.

<sup>9</sup>Ibid. Page 4-6, paragraph 22c.

<sup>10</sup>AICPA Codification of the Statements on Auditing Standards, Section 311.14.

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The working papers do not show whether the field supervisor discussed the disposition of the TFRs with the staff auditors who had originally developed them. The staff auditors also told us that they usually did not see a final copy of the reports. The 1987 to 1989 MERF financial statement audits each produced between 14 and 22 TFRs as potential report issues. The field supervisor made an initial judgment on whether to waive a TFR, communicate it as an oral comment, or include it as a written comment in the management and compliance letter. This initial judgment was subject to change, however, during the central office review or after presenting the final draft to MERF officials. From our review of MERF audits, the OSA process for resolving TFRs and developing report drafts appears very one-directional and did not involve interaction between field and central office staff in order to develop a consensus on these issues.

Some field supervisors expressed concern that the final audit reports did not represent their professional judgment. These supervisors were sometimes disenchanted because their initial report drafts were modified or deleted during the central office review process. In some cases, the supervisors continue to believe that their original report comments were appropriate and did not deserve to be modified or deleted. We only found a couple of instances, though, when these differences of opinion had been documented in the working papers.

### Generally Accepted Auditing Standards for Audit Reporting

We found that the 1987-1989 MERF management and compliance letters were within the parameters of generally accepted auditing standards. It must be understood, however, that the auditing standards offer primarily conceptual guidance for the kind of report comments presented in the State Auditor's 1987-1989 MERF management and compliance letters. The standards did not direct the auditor's decisions on whether to include or exclude the report comments, nor on the style and extent of detail presented in the comments.

As part of each annual financial statement audit, the Office of the State Auditor issued a management and compliance letter. Table 6-2 shows the components of the report.

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**Table 6-2**  
**OSA Management and Compliance Letter Sections**

Internal Control:	Issues relating to the entity's internal control structure established to ensure that assets are safeguarded, and that transactions are authorized, and recorded properly.
Compliance:	Issues identified from tests of compliance with laws, regulations, contracts, and grants.
Management Practices:	Other issues identified during the audit that the auditor believes are questionable or worthy of public disclosure.

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## Special Review: Minneapolis Employees Retirement Fund

Generally accepted governmental auditing standards required reporting on internal control and legal compliance. Auditor judgment played a more significant role in determining whether reports would address management practices. The auditors used the management and compliance letter to satisfy the reporting requirements regarding internal control structure and legal compliance. For legal compliance, auditing standards required the report to disclose "all material instances of noncompliance, and all instances or indications of illegal acts which could result in criminal prosecution."<sup>11</sup> Generally accepted auditing standards also required the auditor to report any matters related to the internal control structure that were material to the MERF financial statements.<sup>12</sup>

Aside from the requirement to report illegal acts, auditing standards obligated the auditor to report only matters material to the financial statements. The Office of the State Auditor did not set a precise materiality amount for its audits of MERF. Since MERF financial statements showed between \$670 million and \$810 million of total assets during 1987 to 1989, a conservative estimate of materiality for an entity that size would be \$3.5 to \$4 million<sup>13</sup>. Unless the auditors estimated that an issue would adversely impact the MERF financial statements by at least that magnitude, the auditing standards did not require them to report on it.

None of the comments changed in the 1987-1990 MERF management letters concerned matters material to its financial statements. Therefore, the changes were fully within the discretion and professional judgment of the Office of the State Auditor, and were not in response to any directives contained in the auditing standards.

A comment that has been cited as an example of an issue that the auditors should not have deleted from the 1989 management letter concerns the extensive delinquencies on the Battle Creek Condominium Mortgages. The entire Battle Creek project was valued at about \$4.5 million, and as of June 30, 1989 the principal and interest payments in arrears were \$283,000. Applying a materiality test to this issue demonstrates that the delinquent amount was not material to the MERF financial statements. In fact, to pass a conservative estimate of materiality, the Battle Creek project would have had to have been worthless. But, the project was not without value; a January 1991, appraisal estimated it was worth about \$3 million. Although the auditor could have included a comment about the Battle Creek project for other reasons, auditing standards did not require a comment.

If an auditor discovers problems that are not material to the financial statements, auditing standards permit the auditor to communicate the issues outside the required reports. The auditing standard regarding nonreportable internal control conditions provides an example of the discretion available to the auditor. It says:

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<sup>11</sup>*Government Auditing Standards* published by the United States General Accounting Office, 1988 revision, page 5-2, paragraph 5.

<sup>12</sup>See *Government Auditing Standards*, page 5-6, paragraph 17 and *Statements on Auditing Standards* published by the American Institute of Certified Public Accountants, Section 325.

<sup>13</sup>*Generally Accepted Auditing Standards* do not offer a means to readily quantify materiality. Auditors have developed widely varying materiality measures in practice. The conservative estimate is based on the most popular materiality scale adopted by government auditors. See the February 1994 issue of the *Journal of Accountancy*, *Materiality in Government Auditing* by K.K. Raman and Relmond P. Van Daniker, pages 71-76.

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*Nonreportable conditions in an audited entity's internal control structure not included in the required reports, should be separately communicated to the audited entity, preferably in writing. Such control structure conditions when communicated in a management letter to top management should be referred to in the report on internal controls. All communications should be documented in the working papers.*<sup>14</sup>

While the Office of the State Auditor communicated some other matters as oral comments at the exit conference, it did not issue separate reports to communicate less material matters.

### OSA Procedures for Report Review

During the time period we reviewed, when staff completed a draft audit report, they submitted it and supporting working papers to the central office for internal review. The office used a checklist to document the review process. Each individual initialed and dated the checklist when they completed their review. The OSA standards and procedures section normally conducted the initial review of the report draft. It reviewed all TFRs and determined that the working papers supported the issues in the report. Next, the legal section performed an initial review. An attorney primarily reviewed the legal compliance section of the report for accuracy and proper interpretation of statutes. The division director then conducted a review, followed by a second quality control review and a second legal review. The report then went to the director of audits, and finally to the State Auditor, for review. Any reviewer could make suggestions for changes in style or substance of the report.

After the central office review process, OSA submitted the draft report to the auditee for review and comment. The auditors held an exit conference with the auditee to discuss the report. After the exit conference, the auditors could make additional changes to the draft report. The auditors then prepared a revised draft, obtained the auditee's comments for inclusion in the report, and submitted it to central office for final review. The State Auditor then signed the report and it was issued. Again, the report was subject to further changes until it was signed.

### 1987 Financial Audit Management Letter

Table 6-3 shows the issues identified in the MERF audit for fiscal year 1987. The draft management and compliance letter contained two comments, which OSA management subsequently removed from the final report. The original report contained the following two comments:

Internal Control:	Timely accounting for transactions (TFR #1)
Management Practices:	Purchase of automobile for executive director (TFR #2)

OSA staff auditors developed the report comments during field work and submitted them in a handwritten draft for central office review. We discussed the MERF board's involvement with the automobile purchase in Chapter 2 and the finding development on that issue in Chapter 3.

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<sup>14</sup>Government Auditing Standards, Pages 5-10, paragraph 25.



**Table 6-3**  
**1987 Financial Statement Audit**  
**Disposition of Tentative Findings**

Tentative Findings	Auditor	Categorized by Field Supervisor	Written Comments In	
			Final Draft	Final Report
1 Computer System did not allow timely recording of accounting transactions.	Flesher	Written Comment	Yes	No
2 Chenoweth used poor judgment to purchase a Jaquar with MERF funds.	Fox	Written Comment	Yes	No
3 One travel claim was excessive. Board member stayed in triple room instead of single room.	Flesher	Oral Comment *	No	No
4 Some expense per diem payments were made at the wrong rate (six payments were at \$55 instead of \$50).	Flesher	Oral Comment *	No	No
5 MERF advanced travel funds to two school board members for a trip.	Flesher	Oral Comment *	No	No
6 Inaccurate posting of dividend data to general ledger.	Flesher	Oral Comment	No	No
7 Need to adjust bond premium & discount amortization schedules.	Fox	Oral Comment	No	No
8 Bond purchases in retired account did not comply with M.S. 11A.24: bonds were not in the top four rating categories.	Fritsch	Oral Comment	No	No
9 Fixed asset purchases should be tagged.	Fritsch	Oral Comment	No	No
10 No receipt listing prepared upon opening mail.	Rashid	Waived, not practical to implement.	No	No
11 Unreconciled difference in bank balance.	Rashid	Waived, immaterial difference.	No	No
12 Many old outstanding checks remain uncashed by the vendors.	Rashid	Waived, prior finding now mostly resolved.	No	No
13 Noncompliance with M.S. 11A.24, Subd. 6. Holding over 20% interest in a limited partnership.	Fritsch	Waived, Fox decided that MERF was in compliance because statute applied to only active portfolio (it held half the investment or about 18%).	No	No
14 Dollar minimum needed for capitalizing fixed assets.	Fritsch	Waived, judged to be immaterial.	No	No

\* Initially Fox categorized these issues as written report comments, but changed them to oral comments before the initial report draft was completed.

Auditor In Charge: Jerry Priess	Initial Draft Completed	12-Jan-88
Field Supervisor: Mary Fox	Final Draft Approved	19-Apr-88
Audit Staff: Jill Flesher, Kurt Fritsch, & Sadar Rashid	Exit Conference Held	17-May-88
	Final Report Issued	02-Dec-88

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Table 6-4 shows the timing and participants in the central office review process. The reasons it took so long to issue the final report are uncertain. The auditors would have substantially completed fieldwork for the 1988 audit by the time OSA issued the final 1987 report. We interviewed the central office reviewers identified in the table (except for support staff), and they could not explain the delay in report issuance or the reasons for removing the two comments from the management and compliance letter.

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**Table 6-4**  
**Fiscal Year 1987 Management Letter**  
**Review Process in 1988**

<u>Completion Date</u>	<u>Action</u>	<u>Performed By</u>
January 19	Report received in office	Support staff
February 16	Initial report review	Greg Hierlinger
March 9	Typing	Support staff
March 23	Footed and proofed	Support staff
March 23	Initial legal review	Tom Gilbertson
March 23	Quality control final review	Donna Cullen
March 24	Division director's review	Gordon Johnson
April 1	Director of audits initial review	Elaine Hansen
April 18	Final typing	Support staff
April 19	Final legal review	Tom Gilbertson
April 19	Director of audits final review	Elaine Hansen
April 19 -- Note 1	State Auditor review	Arne Carlson
December 2	Copying and binding	Support staff
December 2	Report released	Support staff

Note 1: The State Auditor's sign off on the review checklist does not show a specific date; but it appears that ditto marks mean a review on the same date as the director of audits.

Source: Audit checklist form in fiscal year 1987 working papers.

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The draft report copies found in the working papers contain various handwritten notes or questions. Former Director of Audits Elaine Hansen added a note that indicated the office was conducting a management study of MERF. Former State Auditor Carlson confirmed that he had made certain of the handwritten notations. In one note, he suggested adding information about past history to the comment on timely accounting for transactions. His notes on the automobile purchase were primarily informational to enhance his understanding of the issue. The handwritten notes did not suggest or infer that OSA should remove the findings from the report.

Following the review in the central office, former State Auditor Arne Carlson signed the report, which still included the two comments. Jerry Priess, who was the auditor in charge of the 1987 audit, told us that he and staff member Mary Fox subsequently held an exit conference with Mr. Chenoweth. Mr. Priess said that Mr. Chenoweth got extremely angry when he realized the report cited the Jaguar automobile purchase. Mr. Priess said that Mr. Chenoweth referred to the report as a "cheap shot" and told them to seek legal advice because they were in trouble.

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Mr. Priess said that he and Ms. Fox then discussed the comment again, but concluded that Mr. Chenoweth's objections had not persuaded them to change it.

Recollections of what occurred next are hazy. Mr. Priess told us that after the exit conference Gordon Johnson, Municipal Audit Coordinator, called him and indicated that Mr. Carlson said the comment on the automobile purchase had to be rewritten. According to Mr. Priess, Mr. Johnson was to rewrite the comment. Mr. Priess had no further contact with the report, other than to see that the final version did not contain either of the original comments. Mr. Johnson said he does not recall seeing the draft report and does not believe that Mr. Carlson directed him to delete the report comments. He recalls thinking, however, that the office decided to tone down the comment about the automobile purchase.

We found an unsigned letter, dated July 6, 1988, from Mr. Chenoweth to Mr. Carlson in MERF records. The letter referred to previous discussions regarding Mr. Chenoweth's concerns about certain draft report language. It suggested that the draft contained errors of fact and asserts that the MERF board had adequately resolved the automobile issue. The letter concluded that further discussion of the already over-publicized subject would serve no purpose for anyone.

We cannot determine whether Mr. Chenoweth actually sent the letter to Mr. Carlson. Carole Schendel, who was Mr. Chenoweth's secretary, remembered typing the letter and thought she sent it. She could not show us a signed copy, however. No one in the Office of the State Auditor specifically remembers seeing the letter. We did not find a copy of the letter in the audit working papers or in Mr. Carlson's files at the Historical Society. Former State Auditor Carlson does not remember the letter. He also does not remember talking to Mr. Chenoweth about the issue.

Former Director of Audits Elaine Hansen, and others, provided a plausible explanation on why OSA removed the Jaguar automobile comment from the report. They suggested that the office probably decided to include the comment in the management study report instead of the 1987 management and compliance letter. The final management study report did include a discussion of the purchase, within a section entitled Automobile Arrangements. That write-up had much of the same background information as the financial audit comment. It also included additional details on information provided to the MERF board by its legal counsel. However, the management study report did not raise the same questions about the MERF board's role in the purchase and it did not reach as strong a conclusion on the propriety of the transaction.

It is unclear why OSA decided to remove the other finding on timely accounting for transactions. The significant delay in issuing the final report may have been a factor in the decision. MERF may have already resolved the issue by December 1988.

### 1988 Financial Audit Management Letter

Table 6-5 shows the issues identified in the MERF audit for fiscal year 1988. The original draft management and compliance letter was written by field supervisor Kurt Fritsch. It contained the following two comments:

## **Special Review: Minneapolis Employees Retirement Fund**

Internal Control: Retirement Payroll System (TFR #2)

Legal Compliance: Purchase of Compaq Computers (TFR #1)

The draft Mr. Fritsch submitted to central office for review, however, did not contain any findings. The working papers explained Mr. Fritsch's reasons for withdrawing the comments.

The legal compliance comment concerned compliance with Minn. Stat. Section 471.345, requiring competitive bidding for contracts over \$15,000. After preparing the draft report in January 1989, Mr. Fritsch called OSA Legal Counsel Tom Gilbertson and wrote to the Minneapolis City Attorney. He asked both to provide opinions on whether Section 471.345 applied to MERF. The City Attorney did not formally reply, but turned the request over to MERF. Mr. Gilbertson responded that MERF was not subject to the limitations of Section 471.345. Although at the time he disagreed with the conclusion, Mr. Fritsch eliminated the finding from the report.

In testimony Mr. Gilbertson again reiterated his opinion that the statute in question did not apply to MERF. However, he said he would not have objected if the comment was presented as a management practice concern rather than an issue of legal compliance. Mr. Fritsch told us that he did not consider presenting the comment as an internal control or management practice issue.

Mr. Fritsch eliminated the other comment because of time delays in issuing the 1988 management letter. The process was delayed pending the legal advice on competitive bidding, so Mr. Fritsch did not submit the draft report to the central office until June 23, 1989. The original comment questioned MERF's reliance on the payroll system provided by the City of Minneapolis, and recommended that MERF develop an in-house system. After completion of fieldwork in January 1989, Mr. Fritsch learned that the City of Minneapolis would no longer provide the payroll system to MERF. Because MERF began to resolve the problem prior to issuance of the report, Mr. Fritsch withdrew the finding.

**Table 6-5**  
**1988 Financial Statement Audit**  
**Disposition of Tentative Findings**

Tentative Findings	Auditor	Categorized by Field Supervisor	Written Comments In	
			Final Draft	Final Report
1 Computer purchases did not comply with state law requiring competitive bidding.	Fritsch	Written Comment	No	No
2 Retirement payroll system is obsolete and must be replaced.	Flesher	Written Comment *	No	No
3 Inadequate documentation to support \$35 expense reimbursement.	Flesher	Oral Comment	No	No
4 Unreconciled difference in bank balance.	Rashid	Oral Comment	No	No
5 No independent calculation of accrued interest income	Flesher	Oral Comment	No	No
6 Incomplete recording of stock dividends in accounting ledgers.	Flesher	Oral Comment	No	No
7 Two MERF employees used office postage meter for personal mailings and reimbursed later.	Fritsch	Oral Comment	No	No
8 Documentation missing for airfare to Chicago.	Flesher	Waived, invoice was found.	No	No
9 Paid two expense per diems at incorrect rate of \$55, instead of \$50.	Flesher	Waived, immaterial.	No	No
10 Documentation missing for four disbursements.	Flesher	Waived, invoice was found.	No	No
11 Accounting manager signed his own payroll check.	Rashid	Waived, isolated case when the Executive Director was away.	No	No
12 Executive Director receives pay based on Governor's salary, rather than based on performance.	Rashid	Waived, based on board decision.	No	No
13 Lack of documentation for earnings of disability recipients.	Flesher	Waived, earnings verified by phone.	No	No
14 One retirement benefit was underpaid by \$11.	Flesher	Waived, isolated error that was corrected.	No	No
15 No receipt listing prepared upon opening mail.	Rashid	Waived, not practical to implement.	No	No
16 Account receivable unnecessarily established for contribution received in advance.	Rashid	Waived, no effect on statements.	No	No
17 Did not record a receivable for a benefit overpayment.	Rashid	Waived, amount may not be collectible.	No	No
18 Misclassified a receivable.	Rashid	Waived, a misunderstanding.	No	No
19 Did not record a receivable for 1979 prior credits.	Rashid	Waived, a misunderstanding.	No	No
20 Did not redistribute a suspense account.	Rashid	Waived, adjusting entry made.	No	No
21 Need to adjust bond premium & discount amortization schedules.	Flesher	Waived, adjusting entry made.	No	No
22 Accrued interest receivable overstated by \$822.	Flesher	Waived, immaterial.	No	No

\* Initially Fritsch categorized this issue as an oral comment, but changed it to a written comment before the initial report draft was completed.

Auditor In Charge: Jerry Priess	Initial Draft Completed	04-Jan-89
Field Supervisor: Kurt Fritsch	Final Draft Approved	23-Jun-89
Audit Staff: Jill Flesher, Sadar Rashid, & Dave Bjelland	Exit Conference Held	NONE
	Final Report Issued	10-Aug-89

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### 1989 Financial Audit Management Letter

Table 6-6 shows the issues identified in the MERF audit for fiscal year 1989. The draft management and compliance letter that OSA originally submitted to MERF included the following five comments:

Internal Control:	Travel Claims and Policies (TFRs #1, 3, 4) MERFCO -- Collection of Investor Mortgages in Default (TFR #6)
Legal Compliance:	Purchase of Control Data Corporate Obligations (TFR #20) Conflict of Interest -- Applied Vision (TFR #22)
Management Practices:	Transfer of Assets from the Deposit Accumulation Reserve to the Retirement Benefits Reserve (TFR #21)

Because of the MERF board's response to the draft report, OSA made major changes to its comments. OSA removed two of the comments from the report. It also significantly changed the emphasis of another comment.

On May 11, 1990, the MERF board submitted a detailed response to the fiscal year 1989 management and compliance letter. MERF attorneys Donald Willeke and Robert Nardi drafted the response. The board discussed the response at meetings in April 1990. Mr. Willeke told us that he developed the response based on his and Mr. Chenoweth's opinions, as well as the board discussions in April. The board again discussed its response on May 11, 1990. After final revisions, board president Lorna Hubert signed the response and submitted it to OSA. Mr. Willeke also testified that the relationship between OSA and MERF had become adversarial because of the management study. As a result, MERF viewed any OSA report with suspicion. Therefore, the board felt it must have an aggressive response to the 1989 financial audit.

**Table 6-6**  
**1989 Financial Statement Audit**  
**Disposition of Tentative Findings**

Tentative Findings	Auditor	Categorized by Field Supervisor *	Written Comments In	
			Final Draft	Final Report
1 Overpaid Chenoweth \$201 in travel reimbursements.	Rogalla	Written Comment	Yes	Yes
2 Forfeited a \$665 registration fee for conference not attended.	Rogalla	Oral Comment	No	No
3 Travel policy did not specify number of days travelers were eligible for per diem expenses and hotel costs.	Rogalla	Written Comment	Yes	Yes
4 Travel advances are not being settled within 30 days, as required by policy.	Rogalla	Written Comment	Yes	Yes
5 Accounting manager signed his own payroll check.	Rashid	Waived, isolated case when the Executive Director is away.	No	No
6 High incidence of mortgage defaults that are not being renegotiated.	Flesher	Written Comment	Yes	No
7 Property management checkbook not updated completely nor timely.	Fritsch	Oral Comment	No	No
8 Property management security deposit ledger is not updated timely.	Fritsch	Oral Comment	No	No
9 Some inventory items deleted from records without adequate support.	Rashid	Oral Comment	No	No
10 Filing equipment of \$162 listed on fixed asset inventory could not be located.	Rashid	Oral Comment	No	No
11 Dollar minimum needed for capitalizing fixed assets.	Rashid	Oral Comment	No	No
12 Fixed Assets should be tagged.	Rashid	Oral Comment	No	No
13 Did not redistribute a suspense account.	Rashid	Oral Comment	No	No
14 Two errors in account receivable records.	Rashid	Oral Comment	No	No
15 Receivable from Hennepin County not yet collected.	Rashid	Waived, county agreed to pay.	No	No
16 Confusion in posting accounts receivable from Hennepin County.	Rashid	Oral Comment	No	No
17 Questioned whether two receivables for about \$1,000 were collectible.	Rashid	Oral Comment	No	No
18 Questioned whether two receivables for about \$700 were collectible.	Rashid	Oral Comment	No	No
19 Did not have an Accounting Procedures Manual.	Rashid	Written Comment	No	No
20 Purchase of control data bonds did not meet statutory criteria (below grade debt.)	Fritsch	Written Comment	Yes	Yes
21 Transferring below grade debt from the active account to retired account which is prohibited from purchasing these securities directly.	Fritsch	Written Comment	Yes	No
22 Executive director failed to disclose his personal investment in a company that MERF was an investor, Applied Vision. **	Fritsch	Written Comment	Yes	Yes, but changed

\* Mr. Fritsch developed a very preliminary handwritten draft that included a written comment on item 19, but not item 22.

The first typed report draft included a written comment on item 22, but deleted the comment on item 19.

\*\* There was no TFR on this issue. It was developed as a finding after the completion of the regular fieldwork.

Auditor In Charge: Greg Hierlinger	Initial Draft Completed	15-Jan-90
Field Supervisor: Kurt Fritsch	Final Draft Approved	21-Mar-90
Audit Staff: Jill Flesher, Sadar Rashid, & Danette Rogalla	Exit Conference Held	Unknown
	Final Report Issued	22-Jun-90

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Table 6-7 identifies the specific issues debated in the MERF board response. Kurt Fritsch, audit field supervisor, and various OSA management staff reviewed the response. Mr. Fritsch, Greg Hierlinger, Municipal Audit Coordinator, and Tom Gilbertson, Legal Counsel, primarily made the subsequent report changes. They stated that former State Auditor Carlson was not consulted about the report changes.

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**Table 6-7**  
**1989 MERF Management Letter**  
**Analysis of MERF Board Response**

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<b>Travel Claims and Policies:</b>	<p>The board basically agreed with the auditor's recommendation regarding timely submission of travel reimbursements, although it asserted that strict compliance is not always realistic. The board agreed to amend established travel policies to address the auditor's concerns.</p> <p>The board objected to the recommendation that it establish objective guide-lines for the number of days of authorized travel by board members and staff.</p>
<b>Mortgages in Default:</b>	<p>The board disputed the accuracy of the auditor's conclusions regarding follow-up on mortgages in default. The response asserted that the board had not commenced foreclosure procedures because it did not want to take on the additional responsibilities of property management.</p> <p>The board also asked that auditors review the detailed legal counsel billings to acknowledge that MERF was involved in various negotiations on the mortgage program. The response further justified the slow process for resolution of mortgage defaults because of the complicated nature of the agreements.</p> <p>The board acknowledged that some mortgage notes were not performing adequately. However, it reasserted that the mortgage program provided flexibility and other advantages not present with other investment types.</p>
<b>Purchase of Control Data Corporate Obligations:</b>	<p>The board acknowledged that MERF's information on the rating of this corporate obligation was out of date at the time of the purchase. The board inferred that this was an isolated instance.</p>
<b>Conflict of Interest:</b>	<p>The board took exception with the auditor's conclusion regarding conflict of interest and violation of fiduciary duties regarding the Applied Vision investment. The board also concluded that the executive director had not profited personally from the investment.</p> <p>The board reminded the auditor that the board's current policy regarding service on outside corporate boards disagreed with the auditor's conclusions.</p>
<b>Transfer of Assets:</b>	<p>The board questioned the auditor's conclusion regarding the transfer of assets between the active and retired accounts. It thought the transfers were legal and involved isolated occurrences.</p>

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## **Special Review: Minneapolis Employees Retirement Fund**

### **MERFCO -- Collection of Investor Mortgages in Default**

OSA decided to remove the finding on collection of mortgages in default. The original finding disclosed that payments of Battle Creek condominium mortgages, valued at \$4.48 million, had been delinquent since December 1988. The report recommended that the board examine the role of mortgages and develop criteria for pursuing future delinquencies.

Mr. Fritsch testified that he discussed deleting the comment with Mr. Hierlinger. According to Mr. Fritsch, Mr. Hierlinger made the decision to remove the comment from the report. Mr. Hierlinger recalled discussing the issue, but he does not remember who made the decision to remove the comment. Both Mr. Fritsch and Mr. Hierlinger stated that the comment was removed based on the board's response that it was aware of the delinquencies. Mr. Fritsch also said that after receiving the MERF response, he reviewed the attorney billings as the board suggested. He concluded that MERF had done more on the issue than he originally thought. Therefore, they believed there was no further need to report or disclose the issue. This decision illustrates a narrow definition of the report audience. In this case, OSA considered the MERF board to be its primary audience. As a result, the office lost an opportunity to inform others involved in pension fund oversight of a significant concern.

### **Transfer of Assets from the Deposit Accumulation Reserve to the Retirement Benefits Reserve**

OSA also eliminated the comment on transfer of assets. The draft comment discussed two instances when MERF purchased below investment grade debt in its active fund, and within a month, transferred the securities to the retired fund. The auditors interpreted statutes at the time as allowing the active fund to purchase below investment grade debt, but not the retired fund. The statutes further allowed unfettered transfer between the funds. The report cited the inconsistency in statutory investment authority for the two funds and concluded that continuation of this practice could give the appearance that MERF was deliberately avoiding legislative intent. OSA had raised the same issue in its 1984 management and compliance letter and recommended that MERF seek legislative clarification of the issue. At that time, MERF declined to pursue the issue because it believed its practices were appropriate.

None of the staff interviewed specifically remembers who made the decision to eliminate this comment from the report. Mr. Fritsch testified that Mr. Hierlinger told him that the comment was going to be removed. Mr. Hierlinger could not recall why OSA eliminated it and does not remember being involved in the decision. He speculated that the decision could have been based on the board's response. Again, since the board was aware of their concern, the auditors justified removing the comment.

### **Conflict of Interest -- Applied Vision**

OSA significantly changed the original draft comment on conflict of interest. Originally, it included a detailed discussion of MERF's investment in Applied Vision and Mr. Chenoweth's personal investments in the company. As discussed in Chapter 3, the auditors concluded that

## **Special Review: Minneapolis Employees Retirement Fund**

MERF's continued funding of Applied Vision allowed the executive director to personally profit, in violation of Minn. Stat. Section 356A.06, the Public Pension Fiduciary Responsibility Act.

Tom Gilbertson, OSA Legal Counsel, made the major revisions to this finding. He eliminated the detailed discussion of specific Applied Vision investments. In addition, he removed the conclusion that the executive director personally profited from the arrangement. He left in a discussion that OSA could not verify that Mr. Chenoweth had disclosed his Applied Vision position and holdings to the MERF board. He also retained the recommendation that the executive director not participate on the board or as a director of any entity in which MERF invests. David Kenney, another OSA attorney, added a reference that Minn. Stat. Section 356A.06 required filing of economic interest statements by MERF fiduciaries. The final report also retained the original recommendation that the executive director and other fiduciaries should avoid personally investing in venture capital projects in which MERF is a major investor.

Mr. Hierlinger changed the finding title from conflict of interest to fiduciary disclosure.

Mr. Gilbertson testified that they thought conflict of interest was inflammatory, and that disclosure was a better focus for the finding. Mr. Hierlinger said that they made the report changes to cut down on the detail, yet concentrate on the need for fiduciary disclosure. He also again justified removing some details because board members had received a copy of the original report.

Mr. Kenney told us that the effective date of Minn. Stat. Chapter 356A was a consideration in the report revisions. The act was effective on June 2, 1989, 28 days before the end of MERF's fiscal year. OSA decided not to cite violation of that statute, since it had only been in effect for such a short period of time during the audit period.

### **1989 Management Study Report**

It was difficult to determine OSA's process for developing and revising the management study report. Individual roles and responsibilities are unclear. The working papers lack adequate documentation of the process followed. In addition, OSA staff provided some conflicting testimony about the reporting and review process. OSA made numerous changes to the original draft based primarily on the MERF response. Most changes removed opinions and judgments from the report. The changes resulted in an emphatic shift in the tone of the report.

Richard Pietrick, the study supervisor, was primarily responsible for the original report draft. Other auditors assigned to the study also contributed some sections to the report draft. Staff did not hold themselves to documentation standards applicable to financial audits performed in accordance with generally accepted auditing standards. The initial report draft was not in the working papers. Furthermore, there is no documented link between the working papers and the management study report. The working papers do not contain tentative finding sheets (TFRs) or conclusions. The auditors did not number, index, or reference the working papers or the report.

The management study did not have the same internal review process as OSA financial audits. Mr. Pietrick distributed a copy of the draft report to selected OSA staff: Richard Helgeson,

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Deputy State Auditor; Fred Boethin, Director of Audits; Tom Gilbertson, Legal Counsel; David Kenney, Legal Counsel; and Donna Cullen, Standards and Procedures Supervisor. Mr. Pietrick, in a cover memorandum dated January 6, 1989, requested that these reviewers provide him with any comments or questions. Mr. Pietrick testified that he received responses from everyone except Mr. Helgeson and that he made some changes to his original draft based on the information provided. Again, the working papers did not contain any evidence of the responses or the resulting changes made to the draft. Mr. Pietrick also stated that he provided a copy of the draft report to State Auditor Carlson. Mr. Pietrick characterized Mr. Carlson's suggested changes as minimal. Mr. Carlson told us that he saw the draft report just prior to the exit conference. Mr. Carlson said that he read it to become familiar with the issues, and not with the intent to suggest changes. According to Mr. Pietrick, the initial internal review process did not question the use of judgments in the report.

On February 3, 1989, Mr. Pietrick sent the original draft to MERF board member Willis Harris. It is unclear whether Mr. Harris distributed the draft report to other MERF board members. An exit conference to discuss the draft report was held at the Office of the State Auditor on March 10, 1989. Representatives from MERF were Mr. Chenoweth, Mr. Harris and Mr. Willeke, MERF Legal Counsel. OSA attendees included State Auditor Carlson, Mr. Pietrick, Mr. Boethin, Mr. Gilbertson, Mr. Kenney, Ms. Cullen and Mr. Hierlinger. Mr. Carlson told us that prior to the meeting, Mr. Chenoweth spoke to him privately about his objections to the report. He said that Mr. Chenoweth objected mostly to the conflict of interest issues. Mr. Carlson testified to us that he told Mr. Chenoweth that they would have to discuss the issues during the exit conference.

Mr. Carlson chaired the meeting. Mr. Willeke was the primary spokesperson on behalf of MERF. He reviewed the entire draft report and discussed MERF's concerns and objections on a significant number of issues. Several participants described the meeting as contentious, hostile and very emotional. OSA staff said that Mr. Willeke was confrontational. In his testimony to us, Mr. Willeke agreed that the meeting was unfriendly and said that he acted at the outer limits of politeness. Mr. Pietrick and other audit staff defended the report, but Mr. Pietrick told us that at the end of the meeting he knew that the report required some changes.

Mr. Willeke spoke from a 21-page document that has been referred to as the MERF response. It was actually a script or speaking document used by Mr. Willeke in making his presentation during the exit conference. The document was a very confrontational dissection of the report. Mr. Willeke told us that he never intended that the document be considered MERF's formal response to the draft report. However, he said that one of the State Auditor's staff asked for a copy and he provided it. Mr. Willeke said that he prepared the document after discussing the draft report with Mr. Harris and Mr. Chenoweth. The full MERF board never discussed the response prior to the exit conference. The document incorrectly infers that the full board reviewed the report and the response. Two board members, James Lind and Sharon Johns, told us they thought the tone of the response was too adversarial and not businesslike. Neither participated in any meetings involving the preparation of the document. Mr. Lind was a member of the MERF board committee that coordinated the study, but was not able to review the original draft or attend the exit conference. Although some board members disliked the document, they took no actions to retract it as a formal board response to the management study.

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OSA made significant changes to the original draft report after the exit conference. Appendix C identifies the specific changes. Mr. Carlson told us that he continued to believe that the issues in the report were valid but felt that changes in the language were needed. He agreed with MERF that the report style should be more factual instead of accusatory. Mr. Pietrick was ultimately responsible for making the changes. He worked with Tom Gilbertson to change the tone of the report and eliminate judgments. It is unclear which other staff members participated in the revision process. The auditors did not document any meetings or discussions regarding proposed changes to the report.

On the basis of testimony we received from those who participated in editing the report, there appears to have been no pressure or inappropriate influence by State Auditor Carlson to change the report to accommodate MERF. Mr. Pietrick told us that he never met with Mr. Carlson after the exit conference to discuss any potential or actual changes to the report. Mr. Gilbertson also said he did not talk to Mr. Carlson about the report revisions. However, he said it was "understood" that the revisions would be made to change the report to more neutral, less inflammatory language. Mr. Pietrick also said that he did not think that OSA changed its conclusion on the issues, but decided to remove judgments from the report. He told us that Mr. Gilbertson recommended the elimination of these judgments.

The auditors told us that they considered Mr. Willeke's response document throughout the revision process. Mr. Pietrick could not identify any other information he used in changing the report. He said he made many of the changes based on the statements and conclusions in the MERF document. As noted in Appendix C, OSA used the exact words from the MERF response for many changes. Some report changes added clarity and factual information. These changes added more detailed information and explanations of procedures.

An example of a significant revision to the original draft report is the conflict of interest issue. The original draft concluded that the risk to fund assets was greater than the benefits of certain arrangements. The original comment recommended that the executive director be prohibited from serving on outside boards in which MERF also had investments. Auditors revised this issue and followed language in the MERF response. The revised report eliminated the judgment on risk and changed the recommendation to ask the MERF Board to re-examine the authorizations it had given to the executive director. The tone of the final report was significantly milder than the original draft.

Another revision refocused responsibility away from MERF. The original draft discussed whether certain laws and procedures relating to the State Board of Investment applied to MERF. It recommended that the MERF board seek clarification. However, again prompted by the MERF response, OSA revised this recommendation to put the responsibility on the State Board of Investment to notify MERF of any legal changes or administrative interpretations.

In the revised report, the auditors totally deleted some issues developed in the original draft. For instance, the auditors originally recommended that the board should establish a written policy covering out-of-state travel authorizations and should limit the number of board members

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attending conferences. The revised draft did not mention either of these recommendations. Another issue completely deleted from the original draft was a recommendation for a formal code-of-conduct policy.

Our review identified over 30 instances where OSA deleted judgments in the revised report. In at least 10 instances OSA presented MERF's opinions or reasons for actions. The elimination of judgments changed the overall context of the report. The revised report did not contain critical conclusions or evaluations of MERF management. Mr. Pietrick reasoned that the MERF board was in charge of the fund and the auditors could not substitute their judgment for that of the board. It appears that the auditors accepted the conclusions presented in the MERF response and made the changes, without reevaluating the evidence that influenced the initial draft comments.

Mr. Pietrick forwarded a revised draft report to Willis Harris on April 14, 1989. The MERF board met and conferred on the revised report. The board, through Mr. Willeke, responded to the revised report. In a letter to Mr. Pietrick dated May 1, 1989, Mr. Willeke acknowledged that the MERF board agreed in large part with the revised report. The board suggested that four additional items be changed. OSA changed all four items in the report. It is unclear if Mr. Pietrick made these changes directly or if he consulted with Mr. Gilbertson or other staff. Again, there is no documented evidence of any discussions related to these final revisions, and Mr. Pietrick did not recall the process that was followed.

The Office of the State Auditor issued the MERF management study in May 1989. The exact date is unknown. Unlike other special reports issued by the office, the MERF management study did not contain a transmittal letter nor was it signed by State Auditor Carlson. OSA could not explain that omission.

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## Chapter 7. Role of the Office of the State Auditor in Investment Verification

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### *Chapter Conclusions*

*In 1988 and 1989 the auditors concentrated on verifying the historical cost of MERF investments. The accounting principles MERF used in its financial statements required that investments be valued at historical cost, unless a permanent impairment in market value had occurred. The auditors did limited reviews to determine if any investments had suffered permanent impairment of value, which would require a financial statement write down. They focused market value tests on publicly traded stocks and bonds, rather than on the more risky alternative investments that comprised 20 percent of MERF's investments. The auditor's did not perform any special tests of the market value of MERF's real estate holdings and mortgages in 1988 and 1989. They first reviewed property appraisals as a part of the 1991 audit.*

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Investments comprised over 97 percent of MERF assets for fiscal years 1988 and 1989. They generated realized income representing 65 to 70 percent of total MERF revenue during those years. Because of the significant financial activity, the auditors had a responsibility to review investments and ensure that MERF properly reported them in its financial statements. In addition, auditors needed to test compliance with applicable investment laws.

In this chapter, we review the work performed by the Office of the State Auditor relating to investments. We answer the following questions:

**What methods were used during the 1988 and 1989 audits to verify the value of MERF's material assets as reported on the financial statements? Specifically, how did the auditors determine that MERF had valued its real estate-related assets in compliance with the requirements of generally accepted accounting principles?**

In 1988 and 1989, MERF reported investments at cost, amortized cost, or face value in its financial statements, with parenthetical disclosure of current market value.

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### **Finding 9.**

**During 1988 and 1989, the auditors focused their work on investment carrying value. They did limited work to independently verify current value, particularly for nontraditional or alternative investments such as limited partnerships, mortgages, venture capital, and real estate, which comprised 20 percent of the MERF investments.**

The auditors performed various tests to substantiate investment carrying values on the financial statements. They relied on custodian bank pricing to determine current market value for a portion of the portfolio. The auditors did not confirm or test the valuation of other investments that the bank custodian did not independently price, including limited partnerships and certain bonds and notes that were not publicly traded. It is unclear from the working papers how the auditors defined materiality for the audit approach and level of testing. Auditor's directed legal compliance tests to the retired fund, which had more restrictive legal requirements than the active fund.

In planning the 1989 audit, Kurt Fritsch, the field supervisor, identified high risk indicators regarding the control environment of MERF. He found:

- financial decisions are dominated by a single individual;
- undue emphasis placed on meeting earning projections;
- a predisposition to distort financial statements;
- the existence of complex accounting issues and frequent difficult to audit transactions; and
- prior audits detected errors known by MERF that were not voluntarily disclosed to the auditors.

These high risk indicators showed a weak control environment and increased the level of audit effort necessary to reach conclusions, especially on investments.

The auditors first showed concern with certain speculative MERF investments in the 1989 audit, but deferred any additional work to the next year. During 1990, the auditors concurred with the footnote disclosures made by MERF regarding declining market values and possible future losses. In 1991, OSA management considered withdrawing their prior independent auditor's opinion for 1990. OSA management reviewed each of the investment categories reported in the 1990 financial statements and determined that \$92,556,750, or 11 percent of MERF's net assets, created an audit risk because market value was not readily determinable. They concluded that the 1990 financial statements should have included additional disclosures related to:

- the potential impairment of the mortgage portfolio;
- the illiquid nature of limited partnerships;
- the former executive director's fiduciary involvement with certain investments; and
- any additional commitments or contingencies discovered in the confirmation process.



## Special Review: Minneapolis Employees Retirement Fund

However, OSA decided that its concerns with respect to the 1990 audit could be addressed by the timely issuance of the 1991 audit report, rather than reissuance of the 1990 report. In the 1991 audit, auditors reviewed investment write downs and cited uncertainty with certain investment valuations in a separate paragraph of the independent auditor's opinion.

### GAAP and GAAS

The Governmental Accounting Standards Board (GASB) establishes generally accepted accounting principles (GAAP) applicable to governmental entities, including MERF. Under GASB principles, public employee pension plans could follow any one of three different financial reporting models. Prior to 1992, MERF used the model that reported investments in the financial statements at cost or amortized cost, with parenthetical disclosure of market value. GASB standards also required footnote disclosure of the market and credit risk associated with the investment portfolio. In addition, the accounting principles provided that if a decline in market value below cost was other than temporary (a permanent impairment) management should recognize the loss and write down the investment to market value.

The American Institute of Certified Public Accountants (AICPA) establishes generally accepted auditing standards (GAAS) for financial statement audits. *Codification of Statements on Auditing Standards*, AU Section 332.02 established for the time period of our review an auditor's responsibility for examining long-term investments. It said:

*The independent auditor should ascertain whether long-term investments are accounted for in conformity with generally accepted accounting principles consistently applied and whether the related disclosures are adequate. He should, therefore, examine sufficient competent evidential matter supporting the existence, ownership, cost, and carrying amount of investments, income and losses attributable to such investments, and any related disclosures in the investor's financial statements....*<sup>15</sup>

In addition, AU Section 332.03 provided:

*With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor. The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred.*<sup>16</sup>

Both the accounting principles and auditing standards emphasized greater attention by management and auditors when investment market values fall below the carrying amount. Management

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<sup>15</sup>*Codification of Statements on Auditing Standards*, American Institute of Certified Public Accountants, AU Section 332, issued November 1972.

<sup>16</sup>*Codification of Statements on Auditing Standards*, American Institute of Certified Public Accountants, AU Section 332, issued November 1972.

## **Special Review: Minneapolis Employees Retirement Fund**

had to determine whether an investment's value was permanently impaired and had not experienced only a temporary decline. The auditors were to assess whether the evidence established that a permanent impairment had occurred. If the auditor's judgment differs from management, and the difference is material, the auditor must qualify the opinion on the financial statements.

In addition, audit standards (AU Section 332.05) provided guidance on the evidence necessary to support the carrying amount of certain long-term investments, such as limited partnerships, private placements and real estate. Such evidence could be available in the following forms:

- audited financial statements generally constitute sufficient evidence regarding equity in the underlying net assets of an investment;
- unaudited financial statements provide support, but are not by themselves considered sufficient evidential matter;
- market price quotations based on a reasonably broad and active market ordinarily constitute sufficient evidence;
- review of the existence and transferability of any collateral assigned to an obligation may be important in considering its collectibility; and
- appraisals or evaluations may provide evidential matter supporting factors not recognized in the investee's financial statements.

An auditor is not responsible for the investment performance of an entity. Rather, the auditor's role is to attest to the investment balances, and to ensure proper reporting and disclosure of those balances.

The independent auditor does not act as an appraiser of investment values. The presence of uncertain investment valuations itself is not reason to modify the auditor's opinion. The auditor is not responsible for investments maintaining their value into the future, beyond the date of the financial statements. If, however, an auditor discovers significant declines of investment values after the balance sheet date, but before completing fieldwork, a disclosure may be necessary. These disclosures will alert readers to the subsequent loss of value.

### **Office of the State Auditor Testing of Investments**

In the following paragraphs we discuss the specific audit tests performed by the OSA staff in financial audits of MERF for fiscal years 1988 and 1989.

#### **Confirmations of Existence**

The auditors confirmed investment balances with the MERF custodian bank each fiscal year. The custodian bank confirmation presented individual cost and market values for all MERF investments; however, for those investments without a ready market, the custodian used historical

## **Special Review: Minneapolis Employees Retirement Fund**

cost as market value. Auditors reconciled MERF carrying value to the custodian bank balances. This test would provide support for the existence of certain securities, particularly stocks and bonds, which the custodian bank held in paper form or accounted for in book entry form. It also provided documentation of investment cost. However, the test did not provide a complete verification of market values.

The auditors also confirmed portfolio balances with the three external investment managers. The auditors then compared the external manager's balances to MERF records and the custodian bank balances. The auditors encountered no major differences in this test that covered approximately one-third of the fund's total investment portfolio. This test provided a second verification of the investment carrying value.

In 1988 and 1989, the auditors did not confirm other investments, such as limited partnerships, mortgages and certain loans or notes, directly with the applicable entity or debtor. Such confirmations would have provided the auditors with an outside source of information to corroborate MERF's carrying value for those investments. Confirmations are an efficient and reliable source of audit evidence since they are external and independent from MERF valuations. In the 1990 audit, OSA staff requested limited partnership confirmations. However, not all partnerships responded. For example, the confirmation for the Intercap Monitoring Fund investment of \$11.5 million was returned undeliverable. Auditors were not surprised by the undeliverable confirmation because MERF had initiated litigation against the limited partnership.

### **Tests of Investment Cost**

Specific audit tests focused on the cost or amortized cost of investments, rather than market value. The auditors tested individual investment purchase and sale transactions and compared them to bank account records of cash outflows and inflows. The auditors concluded that MERF recorded accurate cost or amortized cost for its investments. The audit tests performed provided good assurance on investment cost.

The auditors also did some additional review of the carrying value for other investments. They reviewed all of the agreements for the limited partnerships and traced to cash outflows and inflows to verify the investment carrying value. For mortgages, the auditors verified the general ledger balance to the detailed listing of individual mortgages. They also reviewed payments received during the year and traced a sample of mortgages to title documents. The auditors expanded their work on mortgages in 1989, and examined board action on delinquent loans.

The auditors did not do any other special tests of the carrying value of MERF real estate investments in 1988 and 1989. In 1991, MERF management initiated appraisals of its real estate portfolio, which the auditor then reviewed.

### **Market Value Tests**

We observed little or no testing of investment market values. OSA staff and management told us that they thought it was important to test market values to an external pricing source. However, auditors apparently relied entirely on pricing provided by the bank custodian. We found no audit verification of custodian market values to any external pricing source, nor any review of third-

## Special Review: Minneapolis Employees Retirement Fund

party assurances on the custodian's pricing process. Jerry Priess, 1988 auditor in charge, told us that in prior years auditors had tested the custodian's pricing and found it reliable. As a result, the auditors may have placed less emphasis on that test during the 1988 and 1989 audits. Reliance on custodian pricing for securities such as stocks and bonds provides some limited assurance. However, for investments that lack a ready market, the custodian bank recorded cost as market value.

The auditors reconciled the market value of external investment manager portfolios to the custodian bank prices. External investment managers often have independent pricing systems. As a result, increased reliability existed on the custodian bank prices for approximately one-third of MERF's investment portfolio.

### Permanently Impaired Investments

In 1988, OSA staff tested certain equity investments for any permanent impairment that would require write downs of carrying values. The auditors selected certain stocks with market value substantially lower than cost at June 30, 1988. They traced the stock prices to the September 6, 1988, *Wall Street Journal* to determine if they had lost further value. They researched the companies' outlook in various industry reference sources. Auditors concluded there was no permanent impairment of these equities. They found that many had a positive outlook. OSA staff discontinued this test in 1989, due to improvements in the recorded market value for stocks.

We saw no evidence in the 1988 and 1989 audits that the auditors determined if certain higher risk investments had any permanent impairment. Limited partnerships and certain below grade debt obligations were illiquid and had no ascertainable market price. Despite the lack of a ready market price, auditor working papers showed no corroboration of these investments to any financial data, such as audited or unaudited financial statements. Such documentation would have established evidence of MERF's equity value in the partnership. Kurt Fritsch, field supervisor, told us that many of the limited partnership investments were relatively new in 1988 and 1989 and showed few signs of difficulties. He told us that he had reviewed financial statements for certain limited partnerships. However, we found no evidence of those reviews in the working papers for the 1988 or 1989 audits.

The 1988 and 1989 audits did not cite any investments that had been permanently impaired, requiring write down. However, Mr. Fritsch made the following observations in the 1989 working papers:

*Fund 39 (retired fund) is getting increasingly speculative. Future audits should review the aforementioned investments (Knight Protective Industries, Good Roads and Gerber Industries, Ultimap, and Intercap), Aquaculture and Applied Vision.....There may become a time when the overall speculativeness of the entire portfolio may require a comment on our part.*

This concern later proved to be well justified. All seven investments cited by Mr. Fritsch were subsequently written down on the 1991 MERF financial statements.

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Various MERF employees testified that they had alerted Mr. Fritsch about the value of certain investments. Mr. Fritsch recalls discussing investments and other issues with MERF employees, but he told us that their concerns related to management philosophy regarding investments. He indicated these employees were not pleased with the fund's investment priorities and its involvement in more speculative investments. In addition, the employees expressed concerns about Mr. Chenoweth's management style. Mr. Fritsch testified that the MERF employees did not provide any evidence of illegal acts or specific justification for any permanent impairment of investment value.

Current and former MERF employees told us about the following information they provided to the auditors in 1988 and 1989:

- MERF employee James Cullen probably had the most information about problems with selected investments. In 1989, at the request of Mr. Chenoweth, he reviewed financial information on the status of Aquaculture Technologies. MERF recorded its stock and debt investments in Aquaculture at \$9.5 million. Mr. Chenoweth sent Mr. Cullen to Louisiana to review financial records for Aquaculture. Mr. Cullen raised concerns about the project's status, and certain of the representations made by project management. On the basis of this information, MERF decided not to provide further funding for the project until Aquaculture Technologies provided proper financial records.

Mr. Fritsch and Mr. Cullen both acknowledge discussing Aquaculture, but there are some conflicts in their testimony. Mr. Cullen testified that he expressed concerns to Mr. Fritsch about Aquaculture during the 1989 audit. Mr. Cullen says that he asserted to Mr. Fritsch that MERF should not report the Aquaculture investment at cost. Rather, Mr. Cullen thought it should be carried at the present value of future cash flows, which he estimated were substantially less than cost. Mr. Cullen said that Mr. Fritsch reacted by saying that "his hands were tied" and "there was nothing he could do about it." However, Mr. Fritsch testified that in 1989 Mr. Cullen assured him that there was sufficient security in Aquaculture assets to cover MERF's investment. Mr. Fritsch also stated that in 1990, Mr. Hacking, the new executive director, asked Mr. Cullen to review additional information on this investment. At that point, according to Mr. Fritsch, Mr. Cullen changed his opinion on the security of MERF's investment in Aquaculture. The 1990 financial statements included footnote disclosure regarding the potential for future losses.

Mr. Fritsch told us that he may have said to Mr. Cullen that "my hands were tied" or "there was nothing I could do." He said he meant that Mr. Cullen's concerns went beyond an auditor's authority. In Mr. Fritsch's opinion, the investment complied with the law. Also, in Mr. Fritsch's judgment, Mr. Cullen had not presented evidence that the investment's value was permanently impaired. Mr. Fritsch testified to us that he was not under pressure from supervisors or anyone else in the Office of the State Auditor regarding reporting of investments. He told us that his response to Mr. Cullen was not intended to suggest that such pressure existed.

## Special Review: Minneapolis Employees Retirement Fund

- Mr. Cullen also testified that he expressed concerns about InterCap Monitoring Funds to Mr. Fritsch during the 1989 audit. Mr. Cullen had also reviewed that investment because MERF had not received distributions from the funds. MERF carried the investment on its financial statements at a cost of \$11.5 million. Again, Mr. Cullen said that he questioned that valuation. Mr. Fritsch does not recall discussing InterCap during the 1989 audit, although he testified it may have happened. However, he does recall reviewing the investment and discussing it with Mr. Cullen during the 1990 audit, after Mr. Hacking became executive director. Again, the 1990 financial statements included disclosures on the status of InterCap and the financial difficulty it had experienced.
- Bruce Nolan, a former MERF accountant, testified that in 1989 he alerted Mr. Fritsch that dozens of MERFCO mortgages were in default. Mr. Fritsch reviewed the mortgage records and agreed there was a problem. Mr. Fritsch testified that he discussed the concerns with former Executive Director John Chenoweth. Mr. Fritsch said Mr. Chenoweth became antagonistic and threatened to sue him if he included the issue in the audit report. However, Mr. Fritsch did not change his opinion and drafted a report comment that MERF was not taking sufficient action to resolve the delinquent loans. As discussed in Chapter 6, OSA management removed this issue from the draft report after being convinced that the board had been responsive to this problem and had its attorneys working on a resolution.

The MERF staff allegations heightened the auditor's awareness of these troubled investments. However, OSA staff did not think that sufficient evidence of permanent impairment existed in 1989. In 1990, the auditors concurred with the MERF disclosures on troubled investments. In 1991, they concurred with the \$58 million write down in carrying value. In addition, the OSA audit opinion for 1991 cited lack of readily ascertainable market values for other investments with a carrying value of \$77,149,627 (7.5 percent of total assets). MERF management estimated that market value for these investments was \$20.4 million lower than the carrying value.

### Legal Compliance Tests

The 1988 and 1989 audits concluded that MERF complied with legal requirements governing fund investments. Legal compliance tests focused on investments of the retired fund, because the auditors believed Minn. Stat. Section 11A.24 had more restrictive criteria. Auditors categorized MERF investments by type to test limits set forth in Minn. Stat. Section 11A.24. Although we question the accuracy of certain of their calculations, we believe the auditors' ultimate conclusions on legal compliance were correct.

The final MERF management letter for 1989 included a finding questioning the MERF retired fund's purchase of a bond that did not meet the rating requirements of Minn. Stat. Section 11A.24, Subd. 3(b). In addition, as discussed in Chapter 3, the auditor also had concerns about the transfer of below investment grade debt from the active fund to the retired fund. In reaching their conclusions in 1989, the auditors did not consider a 1987 legislative change to Chapter 11A.24 that authorized investments in debt obligations not subject to Subd. 3.

## **Special Review: Minneapolis Employees Retirement Fund**

The OSA financial audits did not mention the board's investment policy. The auditors had a copy of the policy in their working papers. However, we found no evidence that they tested compliance with the policy. Although the policy required that asset allocation targets be set and periodically reviewed, the audit reports and management study failed to mention that MERF had not set allocation targets. OSA working papers indicated some frustration in testing the prudence of MERF investments, but did not utilize the board's interpretation of prudence cited in its policy.

## **Special Review: Minneapolis Employees Retirement Fund**

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# **Appendix A** **Special Review: Minneapolis Employees Retirement Fund** **Listing of Contacts**

## **Sworn Testimony**

### **MERF Board Members:**

Daniel Cherryhomes\*  
Walter Dziedzic\*  
Donald Fraser\* (1)  
Willis Harris\*  
Lorna Hubert\*  
Sharon Johns\*  
James Lind\*

### **MERF Employees:**

Larry Brandts\*, Information Services  
Timothy Caza\*, Retirement Counselor  
James Cullen\*, Investment Analyst  
Alan Krohnke, Investment Trader (1)  
Ed Meyers\*, Accountant (1)  
Bruce Nolan, Accountant (1)  
Carole Schendel\*, Secretary  
James Schweitz\*, Administrative Assistant (1)  
Robert Trushenski, Assistant Executive Director (1)

### **Legal Counsel:**

Donald Willeke\*

### **OSA Employees:**

David Bjelland  
Fred Boethin (1)  
Arne Carlson\* (1)  
Donna Cullen  
Jill Flesher (1)  
Kurt Fritsch\*  
Tom Gilbertson (1)  
Elaine Hansen (1)  
Greg Hierlinger\*  
Gordon Johnson (1)  
David Kenney  
Danette McCulley (1)  
Richard Pietrick\*  
Scott Post (1)  
Jerry Priess (1)  
Sadar Rashid  
Tim Sweeney

## **Other Information**

James Engstler, Investment Trader (1)  
James Hacking, current Executive Director

Tom Heffelfinger, Legal Counsel to Governor Carlson  
Judith Johnson, OSA Staff Legal Counsel for State Auditor Dayton (1)  
Richard Matter, OSA Employee (1)  
Ed Stringer, Chief of Staff for Governor Carlson

\* -- Accompanied by legal counsel  
(1) -- No longer serves in this capacity

Note: The following additional individuals testified before the Legislative Audit Commission: State Auditor Mark Dayton; former State Senator Donald Moe; Larry Martin, Executive Director of the Legislative Commission on Pensions and Retirement; Ed Burek, Assistant Executive Director of the Legislative Commission on Pensions and Retirement; and George Soule, legal counsel to Governor Carlson. We subsequently interviewed Mr. Martin and Mr. Burek as a part of this study.

## **Special Review: Minneapolis Employees Retirement Fund**

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## Appendix B

### Special Review: Minneapolis Employees Retirement Fund Chronology of Events

MERF Actions	Date	State Auditor's Actions
○ John Chenoweth starts as Executive Director.	1979	○ Arne Carlson begins term as State Auditor.
	1980	○ Special study on State Board of Investment released.
○ Legislature transfers investment authority for MERF retirees from SBI to MERF.	1982	
○ MERF Board raises Chenoweth's annual salary from \$42,000 to \$70,000.	Apr-83	
○ James Schweitz hired as MERF Administrative Assistant.	Dec-83	
○ Board resolution permits Chenoweth to serve on boards in which MERF invests.	Jul-84	
	Mar-85	○ FY 84 management & compliance letter released.
○ Mortgage program for members established.	1986	
	May-86	○ FY 85 management & compliance letter released.
○ Legislative Auditor issues report on public pension funds, including MERF.	May-86	
	Aug-86	○ St. Paul Port Authority audit report released.
○ Chenoweth tells a legislative commission that he had personal investments in MERF investees and would disclose them privately.	Nov-86	
○ MERF Board raises Chenoweth's salary to maximum allowed by state law.	Dec-86	
○ MERF Board approves \$15,900 toward purchasing a new automobile for Chenoweth.	Jan-87	
○ Chenoweth on Adler & Shaykin advisory panel and credited with gaining additional distributions for MERF.	May-87	○ FY 86 management & compliance letter released.
○ Chenoweth uses car allowance and interest free loan to purchase Jaguar.		
○ Media publicizes Chenoweth's Jaguar purchase following an accident.	Jun-87	
○ MERF Board holds a special meeting to discuss the Jaguar purchase.	Jul-87	
○ Formal agreement reached between Chenoweth and MERF board to sell car and split proceeds.	Sep-87	

## Appendix B

### Special Review: Minneapolis Employees Retirement Fund

#### Chronology of Events

MERF Actions	Date	State Auditor's Actions
<ul style="list-style-type: none"> <li>○ Goose Island Investment approved.</li> <li>○ Jaguar automobile sold.</li> <li>○ Questions from Senator Donald Moe discussed.</li> </ul>	Oct-87	
	Dec-87	○ FY 85-87 State High School League audit report released.
	Jan-88	<ul style="list-style-type: none"> <li>○ Work begins on MERF management study.</li> <li>○ Initial draft of FY 87 MERF management &amp; compliance letter completed.</li> </ul>
<ul style="list-style-type: none"> <li>○ Schweitz contacts Lind to allege that Chenoweth is using cocaine and creating problems in the office. Lind seeks advice from MERF legal counsel, Donald Willeke.</li> </ul>	Apr-88	○ Final draft of FY 87 MERF management & compliance letter approved. [Note: Arne Carlson inadvertently signed this draft report.]
<ul style="list-style-type: none"> <li>○ Lind notifies other board members of Schweitz's allegations.</li> <li>○ ATL investment approved.</li> </ul>	May-88	○ Exit conference held on FY 87 management & compliance letter. Chenoweth is very upset about report comment on his purchase of the Jaguar.
<ul style="list-style-type: none"> <li>○ Chenoweth writes letter to Carlson requesting removal Jaguar issue from report.</li> </ul>	Jul-88	
<ul style="list-style-type: none"> <li>○ Schweitz repeats allegations to Lind.</li> </ul>	Aug-88	○ Elaine Hansen ends employment at OSA and Fred Boethin is named director of Audits .
	Oct-88	○ Management study questionnaire sent to MERF board.
<ul style="list-style-type: none"> <li>○ MERF board responds to study questionnaire.</li> <li>○ Some board members learn of Chenoweth's service on the ATL board of directors.</li> </ul>	Nov-88	
<ul style="list-style-type: none"> <li>○ Chenoweth sends letter to board indicating he will resign from outside boards.</li> <li>○ Schweitz repeats his allegations to Lind &amp; Harris.</li> <li>○ Board members discuss Schweitz allegations with Chenoweth &amp; Willeke. Members do not believe allegations and support Chenoweth.</li> <li>○ ATL requests more money from MERF.</li> </ul>	Dec-88	○ FY 87 management & compliance letter released.
<ul style="list-style-type: none"> <li>○ Board hired Hayes consultants for a personnel study.</li> <li>○ Board Member Johns requests new board procedures.</li> <li>○ Review of portfolio analysis from management study.</li> <li>○ Chenoweth fires James Schweitz.</li> </ul>	Jan-89	<ul style="list-style-type: none"> <li>○ Original draft of MERF management study report is reviewed in Central Office.</li> <li>○ Initial draft of FY 88 MERF management &amp; compliance letter completed.</li> </ul>
<ul style="list-style-type: none"> <li>○ Chenoweth sends James Cullen to examine ATL records.</li> </ul>	Feb-89	○ Draft management study report submitted to MERF.
<ul style="list-style-type: none"> <li>○ Board personnel committee discusses renewing Chenoweth's contract for 3 years, instead of 5 years.</li> </ul>	Mar-89	○ Exit conference held on the management study.

## Appendix B

### Special Review: Minneapolis Employees Retirement Fund

#### Chronology of Events

MERF Actions	Date	State Auditor's Actions
<ul style="list-style-type: none"> <li>○ Chenoweth refuses contract renewal, offers to present a proposal for restructured position in future.</li> <li>○ Hayes personnel study completed.</li> </ul>	Apr-89	<ul style="list-style-type: none"> <li>○ FY 88 State High School League audit report released.</li> </ul>
<ul style="list-style-type: none"> <li>○ Willeke sends letter to Pietrick requesting additional changes to management study.</li> <li>○ Chenoweth discovers ATL on verge of bankruptcy</li> <li>○ Ultimap and Gerber investments approved.</li> <li>○ Chenoweth has Cullen review Intermap because no distribution was received last quarter.</li> </ul>	May-89	<ul style="list-style-type: none"> <li>○ MERF management study released.</li> </ul>
<ul style="list-style-type: none"> <li>○ MERF becomes subject to the new public pension fiduciary responsibility act.</li> <li>○ Chenoweth told board member there were no investments in junk bonds.</li> </ul>	Jun-89	<ul style="list-style-type: none"> <li>○ Final draft of FY 88 MERF management &amp; compliance letter approved and sent to MERF.</li> </ul>
<ul style="list-style-type: none"> <li>○ Board learns of financial troubles at ATL.</li> </ul>	Jul-89	<ul style="list-style-type: none"> <li>○ Letter from City of Winona alleges Chenoweth conflict with Applied Vision Systems, Inc.</li> </ul>
	Aug-89	<ul style="list-style-type: none"> <li>○ FY 88 management &amp; compliance letter released.</li> </ul>
<ul style="list-style-type: none"> <li>○ Board refuses additional funds to ATL until audited financial statements are provided.</li> <li>○ Board approves Red Oak's Adventure resorts and Knight Protective investments.</li> </ul>	Sep-89	
<ul style="list-style-type: none"> <li>○ Chenoweth's contract at MERF expires.</li> <li>○ Chenoweth has a hostile meeting with Intermap about its financial status.</li> <li>○ At annual MERA meeting, Chenoweth announced his position at MERF would change.</li> </ul>	Oct-89	
<ul style="list-style-type: none"> <li>○ Converted \$390,000 of Ultimap debt to equity.</li> <li>○ Chenoweth announces he will retire, but will stay on for at least 45 days.</li> </ul>	Dec-89	
<ul style="list-style-type: none"> <li>○ Board begins search for new Executive Director.</li> </ul>	Jan-90	<ul style="list-style-type: none"> <li>○ Initial draft of FY 89 MERF management &amp; compliance letter completed.</li> </ul>
<ul style="list-style-type: none"> <li>○ Chenoweth will not renew contract, is waiting for direction from board.</li> </ul>	Feb-90	
<ul style="list-style-type: none"> <li>○ Board discusses Applied Vision and possible conflict of interest by Chenoweth.</li> </ul>	Mar-90	<ul style="list-style-type: none"> <li>○ Final draft of FY 89 MERF management &amp; compliance letter approved and sent to MERF.</li> <li>○ Letter sent to MERF board asking about Chenoweth's personal investments.</li> </ul>

## Appendix B

### Special Review: Minneapolis Employees Retirement Fund

#### Chronology of Events

MERF Actions	Date	State Auditor's Actions
<ul style="list-style-type: none"> <li>○ Board approved new policy/procedure manual.</li> <li>○ Chenoweth gives resignation effective upon acceptance.</li> <li>○ Chenoweth suggests that two board members may have possible conflicts of interest.</li> </ul>	Apr-90	
<ul style="list-style-type: none"> <li>○ Board accepts Chenoweth's resignation.</li> <li>○ Board objects to findings in 1989 OSA management &amp; compliance letter draft.</li> <li>○ IAI reviews investment portfolio, finds junk bonds.</li> </ul>	May-90	
<ul style="list-style-type: none"> <li>○ Board votes to sell junk bonds.</li> </ul>	Jun-90	<ul style="list-style-type: none"> <li>○ FY 89 management letter released.</li> </ul>
<ul style="list-style-type: none"> <li>○ Board hires James Hacking as new Executive Director.</li> <li>○ Board loans additional \$800,000 to ATL in exchange for it dropping a potential lawsuit.</li> </ul>	Aug-90	
<ul style="list-style-type: none"> <li>○ MERF sues Red Oak.</li> </ul>	Oct-90	
<ul style="list-style-type: none"> <li>○ MERF and InterCap sue each other.</li> <li>○ Board adopts ABI standards for investment, prohibits Executive Director from serving on boards.</li> </ul>	Nov-90	
<ul style="list-style-type: none"> <li>○ MERF sues ATL.</li> </ul>	Dec-90	
	Jan-91	<ul style="list-style-type: none"> <li>○ Arne Carlson's term as State Auditor ends.</li> <li>○ Mark Dayton starts term as State Auditor.</li> </ul>
<ul style="list-style-type: none"> <li>○ MERF filed lawsuit against Chenoweth.</li> </ul>	Mar-91	
	May-91	<ul style="list-style-type: none"> <li>○ FY 90 management &amp; compliance letter released.</li> </ul>
<ul style="list-style-type: none"> <li>○ MERF writes down investments by \$58 million on its FY 1991 financial statements.</li> </ul>	Jun-91	
<ul style="list-style-type: none"> <li>○ Chenoweth killed.</li> </ul>	Aug-91	

## **Appendix C**

### **Special Review: Minneapolis Employees Retirement Fund MERF Management Study Analysis of Changes to Draft Report**

The attached schedule provides an analysis of the various changes that the Office of the State Auditor (OSA) made to the draft management study report. (See Chapter 6 for an explanation of the review process.)

The schedule includes the following information:

**ORIGINAL DRAFT** Comments as presented in the original draft report submitted to board member Willis Harris in February 1989.

Comments are referenced by page number and are presented in the order included in the report. For example, "2DRAFT183" indicates page 183 of the original draft (2DRAFT). It appears that OSA prepared the Introduction and Executive Summary after the Detailed Chapters, and then reassembled the report in the order shown.

**REVISED DRAFT** Revisions made by OSA following the review by MERF representatives and the exit conference held on March 10, 1989.

Comments again reference page number. For example, "3DRAFT3" indicates page 3 of the revised draft (3DRAFT).

**FINAL REPORT** Final report language. Identified as "Same" if no changes were made to the revised draft.

**COMMENTS** Our identification of the basis for the changes. In most cases, changes to the original draft were based on a document prepared by Donald Willeke, MERF legal counsel. (Identified as "Change prompted by MERF response." or "Verbatim change taken from MERF response.") Changes to the revised draft were based on a formal MERF board response. (Identified as "Final change prompted by MERF board response.")

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
INTRODUCTION			
<p>2DRAFT183</p> <p>This portion of the special examination of the Minneapolis Employees Retirement Fund (MERF) addresses questions raised about the Fund's management. The areas that came under examination were based, in large part, on an identification and compilation of various items of interest or concern that have been raised or expressed about the administration of the Fund. Certain of these items are financial related while others are policy oriented.</p>	<p>3DRAFT3</p> <p>This portion of the special examination of the Minneapolis Employees Retirement Fund (MERF) is a response to questions asked by Senator Donald Moe in a letter dated November 6, 1987. The question's in Senator Moe's letter were based on a response by the Executive Director of the Legislative Commission on Pensions and Retirement to Senator Moe's request of the Commission's Executive Director to identify and compile various items of interest or concern regarding MERF. Certain of these items were financial related while others were policy oriented. During meetings held in the Office of the State Auditor, representatives of the MERF Retirement Board agreed to the scope of this study.</p>	Same	Change prompted by MERF response. Portions taken verbatim from response.
<p>2DRAFT183</p> <p>Because of the diversity of the items of interest or areas of concern addressed in this portion of this special examination, any recommendations made or summaries and conclusions drawn are presented, where appropriate, within the various sections of this report. The recommendations are presented to assist MERF in improving accounting practices and controls. Progress on implementing all the recommendations will be reviewed during the Fund's next audit.</p>	[DELETED]	Same	Change prompted by MERF response.
<p>2DRAFT183</p> <p>We have attempted to respond to the questions raised.</p>	<p>3DRAFT3</p> <p>We have attempted to respond to the questions raised by Senator Moe.</p>	Same	Change prompted by MERF response.

### EXECUTIVE SUMMARY



# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
2DRAFT179  This report addresses questions raised about the management of the Minneapolis Employees Retirement Fund (MERF), the largest of the local public employee pension funds in Minnesota.	3DRAFT4  This report is a response to questions asked by Senator Donald Moe in a letter dated November 6, 1987, about the Minneapolis Employees Retirement Fund (MERF), the largest of the local public employee pension funds in Minnesota.	Same	<i>Change prompted by MERF response. Taken verbatim from response.</i>
2DRAFT179  The areas under examination in this report were based, in large part, on an identification and compilation of various items of interest or concern that have been raised or expressed about the Fund's administration. Certain of these items are financial related while others are policy oriented.	3DRAFT4  The questions in Senator Moe's letter were based on a response by the Executive Director of the Legislative Commission on Pensions and Retirement to Senator Moe's request of the Commission's Executive Director to identify and compile various items of interest or concern regarding MERF. Certain of these items were financial related while others were policy oriented. During meetings held in the Office of the State Auditor, representatives of the MERF Retirement Board agreed to the scope of this study.	Same	<i>Change prompted by MERF response.</i>
2DRAFT179  The Executive Director is a strong, active manager of MERF.	3DRAFT4  The Executive Director is a strong, active manager of MERF, especially qualified in the understanding of investments. The Executive Director carries out the policies established by the Retirement Board. It is the Executive Director's responsibility to recommend actions to the Board and to provide information to the Board. The MERF Board has the responsibility for making decisions within the requirements of their joint fiduciary responsibility.	Same	<i>Additions to text, discussed somewhat in MERF response, which was more directed at deleting other language. Portions taken verbatim from response.</i>
The Retirement Board appears to follow the Executive Director, but with evidence of independence in judgment.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
Because of the strength of the Executive Director, we believe increased oversight by the Board is required to fulfill its	Because of the strength of the Executive Director, we believe increased oversight by the Board is required to fulfill their	Deleted	<i>Change prompted by MERF board final response.</i>

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

#### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
responsibilities.	responsibilities.		
Additional attention to the broader interests of the public is necessary because of the limited involvement of the city representatives and the understandable emphasis of the Board and Executive Director on MERF members' interests.	[DELETED]	Same	Change prompted by MERF response.
2DRAFT179/180	3DRAFT4,5		
The Fund's current financial reporting and accounting practices relative to administrative costs are a reflection of its current statutory authority and management's internal budgeting practices.	The Fund's current financial reporting and accounting practices relative to administrative costs are a reflection of its current statutory authority and management's internal budgeting practices. The State Board of Investment has adopted procedures which apply portions of its total operating budget against assets of the portretirement investment fund. MERF continues to follow the allocation procedures originally utilized by the Investment Board when MERF's proportional participation share of the assets and obligations in the post-retirement investment fund were returned to the Fund in the early 1980's. Because the Investment Board's changes in procedures may be the result of legal or administrative interpretations, we believe the responsibility to notify MERF of these interpretations rests with the State Board of Investment. Outlays for administration have been identified that are related to the Retired account. If these outlays were charged against Retired Account investment income, a more meaningful match of the resources used to generate Retired Account investment income with the income generated by those resources would be provided. A reduced state financial liability to the Fund may also result, though how much is uncertain.	Same.	Added comments related to SBI practices.
The Retirement Board needs to seek clarification of issues raised regarding applicability of State Board of Investment allocation procedures regarding the Fund's operating budget. If these procedures are found to be applicable to the Fund, the State could perhaps gain from a reduced financial liability.	[DELETED]	Same	Change prompted by MERF response.

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
<p>Per-member administrative cost comparisons are difficult to make because of a lack of comparable data among the various public pension plans. The Retirement Board still must, however, monitor administrative costs carefully. Annual financial audits conclude that, as a whole, administrative expenses were both reasonable and necessary. We do not believe any errors or irregularities in the Fund's administrative expense practices have occurred that would be material in relation to the Fund's financial statements taken as a whole.</p>	<p>Per-member administrative cost comparisons are difficult to make because of a lack of comparable data among the various public pension plans. The Retirement Board still must continue to monitor administrative costs carefully. The Fund's annual financial and compliance audits are performed in accordance with generally accepted auditing standards. Such standards require that audits are planned and performed to obtain reasonable assurance that the financial statements are free of material misstatement. This would include examining, on a test basis, evidence in support of the amounts and disclosures in the financial statements. The results of these tests would appear to indicate that as a whole, administrative expenses typically are properly recorded and classified to permit their fair presentation in the Fund's financial statements. In addition, conclusions that the expenses are sufficiently documented, reasonable, necessary and serving a public purpose appear to have been reached. Items arise that may not successfully support these conclusions or stand these tests but experience has shown that these items represent isolated occurrences immaterial to the financial statements. We do not believe any errors or irregularities in the Fund's administrative expense practices have occurred that would be material in relation to the Fund's financial statements taken as a whole.</p>	Same	<i>Additional language added to clarify audit work and standards.</i>
<p>2DRAFT180</p> <p>The Executive Director has served on advisory committees and on the boards of directors of various entities in which the Fund has invested.</p> <p>This involvement poses the potential for a conflict of interest. The Executive Director's fiduciary responsibility to protect the assets of the Fund is of paramount concern. In our opinion, the risk to the assets of the Fund overshadows the investment related activities. The Retirement Board should not place the</p>	<p>3DRAFT5</p> <p>The Executive Director has served on advisory committees and on the boards of directors of various entities in which the Fund has invested.</p> <p>The Executive Director has received meeting and director's fees from some of these entities. The Executive Director's ability to participate in outside investment related activities and to accept the normal stipends for such activities was authorized by the Fund's Retirement Board. The Executive</p>	Same	<p>Same except: ...presents several "potential" conflict of interest questions.</p> <p><i>Original change prompted by MERF response. Final change prompted by MERF board response.</i></p>

Appendix C  
 Special Review: Minneapolis Employees Retirement Fund  
 MERF Management Study  
 Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
<p>Executive Director in situations where there is a potential for risk of loss of the Fund's assets or where there is a potential for or appearance of a conflict of interest.</p>	<p>Director's involvement in and payment by entities in which the Fund has made financial investments presents several conflict of interest questions. Our concerns focus on the compensation the Executive Director receives through such participation and the exposure to the Fund by such involvement.</p>		
	<p>MERF's purpose in authorizing the Executive Director to participate in corporate boards and investment committees is to provide additional oversight for the Fund's investments. MERF has indicated several specific examples in which the Executive Director's involvement was instrumental in saving large amounts of money for all shareholders, including MERF. MERF views its approach as part of a national trend in which pension funds are responsibly seeking an active role in the corporations in which they invest. MERF argues that no conflict of loyalties exists because MERF's interest as a corporate shareholder is exactly the same as the other shareholders.</p>	Same	Change based in part on MERF response.
<p>2DRAFT180</p> <p>It is difficult to judge whether these mortgage investments are producing returns comparable to other Fund investments because the mortgages are valued at par rather than market. Yields available on U.S. Treasury securities did not appear to differ materially from the 10.5 percent interest rate on the mortgages.</p>	<p>3DRAFT6</p> <p>The bi-weekly program was set up as an investment and as a cash flow tool for the Fund. Mortgages present an attractive stream of steady cash flows that are in turn re-invested or are used to meet benefit obligation payments without the risk of capital loss inherent in holding interest bearing securities which may have to be liquidated under some circumstances to meet payments. We are not in a position to judge whether the Fund could have done just as well with alternative investment vehicles. This is a matter upon which reasonable prudent persons may differ in the management of the sums for which they have fiduciary responsibility.</p>	Same	Change based in part on MERF response.
<p>2DRAFT180</p>	<p>3DRAFT6</p> <p>The Retirement Board has the</p>	<p>ral authority to administer</p> <p>Same</p>	

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
	the Fund and its duties are to provide for and administer retirement benefits.		
The Retirement Board felt that both its retirees and the Fund could benefit from a limited duration wills preparation program conducted in-house by present staff.	The Retirement Board felt that both its retirees and the Fund could benefit from a limited duration wills preparation program conducted in-house by present staff and that such a program was a reasonable measure to improve service to plan participants.	Same	<i>Changes based primarily on MERF response.</i>
Retirees interested in the program apparently exceeded the Board's expectations.	Retirees interested in the program apparently exceeded the Board's expectations and part-time individuals were employed to complete the program.	Same	
Had the Board monitored the costs of this program effectively, it would have been clear to the Board that the costs of providing this service perhaps were exceeding the value to the Fund.	The cost of printing mailings and forms, and the costs associated with the services provided by the individuals employed on a part-time basis amounted to approximately \$8,849 between July 1984 and October 1985.		
2DRAFT181	3DRAFT6		
Though there would appear to be many close ties between MERF and the MERF Association, the Association is not controlled by the MERF Retirement Board and is an entity separate from the Fund.	The MERF Association is not controlled by the MERF Retirement Board and is an entity separate from the Fund.	Same	<i>Changes not addressed in MERF response.</i>
2DRAFT181	3DRAFT7		
MERF Board members and employees travel frequently to pension and investment related conferences and meetings. The Board needs to expand upon its present travel policy in ways that (1) ensure each trip taken out-of-state is authorized in advance, (2) limit the members attending conferences and seminars and (3) clearly address the issue of travel advances for individuals who accompany Board members or employees.	MERF Board members and employees travel to pension and investment related conferences and meetings. The Board needs to expand upon its present travel policy in ways that clearly address the issue of travel advances for individuals who accompany Board members or employees.	Same	<i>Change prompted by MERF response.</i>
The Retirement Board should also document the policy or	The Retirement Board believes its policy requiring potential	Same	<i>Portions taken verbatim from response.</i>

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
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practice it has developed relative to its position that required potential investment partners cover the Fund's costs for travel and other expenses necessary for inspection and negotiation.

investment partners cover the Fund's costs and out-of-pocket costs of Board member and employee travel and other related expenses necessary for inspection, negotiation, and legal fees is no different from the policy of most other major investment institutions and is a standard throughout the banking and institutional lender industry. The Board should put its policy in writing. The Board believes it has a fiduciary responsibility to MERF beneficiaries to minimize the cost to the Fund for investigating investments.

#### DETAILED CHAPTERS

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2DRAFT3

The City of Minneapolis, though the predominant employer group, does not exercise oversight responsibility over the Fund. The City is represented by two members on the Board of Directors.

3DRAFT9

With the exception of the Mayor of the City of Minneapolis and one member of the Minneapolis City Council, the Fund's seven member Board of Directors is elected by members of the Fund. The City, though the predominant employer group, exercises no significant control over the Fund's finances or tax levy. The responsibility for amortizing the unfunded liability is shared by the participating employers and the State of Minnesota.

Same

*Changes not addressed in MERF response.*

2DRAFT5

3DRAFT11

The Fund's basic financial statements conform to generally accepted accounting principles as applicable to governmental units. The Government Finance Officers Association of the United States and Canada awarded a Certificate of Conformance in Reporting to MERF for its comprehensive annual financial report for the fiscal year ended June 30, 1983. Each subsequent comprehensive annual financial report for the Fund has been awarded a Certificate of Conformance or, for the reports issued after the fiscal year ended June 30, 1984, a

Same

*Changes not addressed in MERF response.*

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

	ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
		<p>Certificate of Achievement for Excellence in Financial Reporting. To be awarded a Certificate, the Fund must publish an easily readable and efficiently organized comprehensive annual report, whose contents must conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements. A Certificate is valid for a period of one year only.</p> <p>A summary of the number of employees, members, and assets of the Fund follows.</p>		
2DRAFT8		3DRAFT14		
<p>∞ 5</p> <p>...Board members hold to the belief they have the final....</p>		...Board members believe they have the final....	Same	<i>Change prompted by MERF response.</i>
2DRAFT8		3DRAFT14		
		<p>Board members point out that (1) the fiduciary responsibility of the members of the MERF Board is to its members and to no one else and that Minn. Stat. Ch. 422A is quite clear on that point, (2) if the MERF Board members did not exercise their duties as trustees for the benefit of the MERF beneficiaries they could be subject to disciplinary action and lawsuits and (3) while it may be our wish that the broader interests of the public be given additional attention, such is simply not the law.</p>	<p>Same except: ...(3) while it may be wished that ....</p>	<p><i>Revised draft change taken verbatim from MERF response.</i> <i>Final change prompted by MERF board response.</i></p>
2DRAFT8		3DRAFT14		
<p>The Executive Director appears to maintain tight control over MERF operations. Almost all decisions seem to be strongly influenced by him. The Executive Director views himself as a significant risk-taker with authority to do all necessary things not prohibited. This can be contrasted with a belief in the authority to do only those things as are specifically allowed</p>		<p>The Executive Director appears to maintain tight control over MERF operations. The Executive Director is willing to take risks when necessary and prudent to do so, and believes he has the authority to do all necessary things not prohibited within the bounds imposed by the prudent person standard at all times.</p>	Same	<i>Verbatim change taken from MERF response.</i>

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by law. In other words, he sees himself as having broader rather than more conservative authority.			
2DRAFT8	3DRAFT14		
For reasons not determined, the Mayor and City Council representatives often do not attend Board of Director meetings.	The Mayor and City Council representative often do not attend Board of Director meetings. During calendar years 1984 to 1987 inclusive, fewer than one-half of the Board's regular meetings were attended by either the Mayor or City Council representative. A designee from the City Coordinator's Office has been attending meetings of the Retirement Board.	Same	<i>Changes not addressed in MERF response.</i>
2DRAFT8	3DRAFT15		
98 In our opinion the Executive Director is a strong, active manager of MERF, especially qualified in the understanding of investments. The Board appears to follow the Executive Director, but with evidence of independence of judgment. The Board appears satisfied with MERF's management direction.	The Executive Director is a strong, active manager of MERF, especially qualified in the understanding of investments. The Executive Director carries out the policies established by the Retirement Board. It is the Executive Director's responsibility to recommend actions to the Board and to provide information to the Board. Once that is done, the MERF Board has the responsibility for making decisions within the requirements of their joint fiduciary responsibility.	Same	<i>Verbatim change taken from MERF response.</i>
2DRAFT8	3DRAFT15		
Because of the strength of the Executive Director and his willingness to accept risk, we believe increased oversight by the Board is required to fulfill their responsibilities.	Because of the strength of the Executive Director, we believe increased oversight by the Board is required to fulfill their responsibilities.	[DELETED]	<i>Change prompted by MERF response.</i>
2DRAFT8	3DRAFT15		
In our opinion additional attention to the broader interests of the public is necessary in the deliberations of MERF affairs because of the limited involvement of the Mayor and City Council representative, and the understandable emphasis of the Board and Executive Director on MERF members' interests.	[DELETED]	Same	<i>Change prompted by MERF response.</i>



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ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
2DRAFT12	3DRAFT19		
While the Fund has not performed any formal analysis to prove (or disprove) this convention, it does provide a consistent approach in allocating such costs.	This convention has provided a consistent approach in allocating such costs and should continue to be periodically reevaluated.	Same	<i>Change prompted by MERF response.</i>
2DRAFT13	3DRAFT20		
...pursuant to section 11A.18..."	...pursuant to section 11A.18, and any legal or administrative interpretations of those laws of the state board of investment, the legal advisor to the board of investment and the executive director of the state board of investment..."	Same	<i>Changes not addressed in MERF response.</i>
2DRAFT13	3DRAFT20		
If MERF's Retirement Benefits Fund is to follow the applicable laws governing the accounting procedures and other applicable operations and procedures regarding the Minnesota post-retirement investment fund, we recommend that MERF's Retirement Board direct the Minneapolis City Attorney's Office to seek clarification as to the applicability of the State Board's procedures relative to MERF's Retirement Benefits Fund.	MERF continues to follow the allocation procedures originally utilized by the Investment Board when MERF's proportional participation share of the assets and obligations in the Minnesota postretirement investment fund were returned to the Fund in the early 1980's. Because some of the Investment Board's changes in operations and procedures regarding the operation of the postretirement investment fund may be the result of legal or administrative interpretations, and therefore not statutory changes, there in all likelihood would be no reason for MERF's management to become aware of these changes if the State Board of Investment does not communicate these interpretations in some form to MERF. We believe the responsibility to notify MERF as well as MERF's independent auditors of any such legal or administrative interpretations regarding the operation of the postretirement investment fund rests with State Board of Investment, and the Investment Board should be mandated to communicate these interpretations to those parties.	Same	<i>Change prompted by MERF response.</i>

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ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
2DRAFT13	3DRAFT21		
Legitimate concerns have been expressed relative to ....	Senator Moe inquired as to ....	Same	<i>Change prompted by MERF response.</i>
2DRAFT14	3DRAFT21		
As we pointed out earlier, it has come to our attention that the State Investment Board has commenced procedures which apply portions of its total operating budget against assets of the postretirement investment fund. Here again, we recommend that MERF's Retirement Board direct the Fund's official legal representative to seek clarification as to the applicability of these procedures to MERF's Retirement Benefits Fund.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
2DRAFT14	3DRAFT21		
...at least in theory.	"...at least in theory, but with a precautionary note. Because administrative expense is only one of many factors (such as investment return) that affect the State's liability to the Fund, it is not possible to predict changes in the State's overall liability. This discussion can only address that portion of the determination of the State's liability that is affected by administrative expense.	Same	<i>Changes not addressed in MERF response.</i>
2DRAFT14	3DRAFT21		
...directly against fund earnings, then the State could stand to gain (though probably not materially) from a reduced financial liability to the employers of the Deposit Accumulation. If presumably, the State's liability is limited to the employers of the Deposit Accumulation, then the State's gain comes from two sources. The first...	...directly against fund earnings, then the State's financial liability to the employers of the Deposit Accumulation could be reduced, though probably not materially. If, presumably, the State's liability is limited to the employers of the Deposit Accumulation, then the State's gain or reduction in its financial liability comes from two sources. The first....	Same	<i>Changes not addressed in MERF response.</i>
2DRAFT14	3DRAFT22		

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ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
<p>...policy or requirements, the State could perhaps make a more material gain from a reduced financial liability to the employers of the Fund's Deposit Accumulation if the Fund is required to allocate directly against Retired Account fund earnings.</p> <p>2DRAFT15</p> <p>Concerns have risen that...</p> <p>2DRAFT16</p> <p>...percentage of total assets nor were we able to replicate....</p> <p>2DRAFT19</p> <p>...each Board member review in more detail the total amounts of administrative expenses....</p> <p>2DRAFT20</p> <p>...budgeting practices, though the Fund needs to seek clarification of issues raised regarding applicability of a State Board budget.</p>	<p>...policy or requirements, the reduction in the State's financial liability to the employers of the Fund's Deposit Accumulation could be more material if the Fund allocated directly against Retired Account fund earnings.</p> <p>3DRAFT22</p> <p>Senator Moe's letter raised the concern that....</p> <p>3DRAFT23</p> <p>...percentage of total assets nor did we attempt to replicate...</p> <p>3DRAFT26</p> <p>...each Board member engage in a more detailed review of the amounts of administrative expenses....</p> <p>3DRAFT27</p> <p>...budgeting practices. The State Board of Investment has adopted procedures which apply portions of its total operating budget against assets of the postretirement investment fund in addition to applying portions of custodial fees and fees for external managers against those assets. These procedures commenced in fiscal year 1986. MERF continues to follow the allocation procedures originally utilized by the Investment Board when MERF's proportional participation share of the assets and obligations in the postretirement investment fund were returned to the Fund in the early 1980's. Because some</p>	<p>Same</p> <p>Same</p> <p>Same</p> <p>Same</p> <p>Same</p> <p>Same</p>	<p><i>Changes not addressed in MERF response.</i></p> <p><i>Change prompted by MERF response.</i></p> <p><i>Changes not addressed in MERF response.</i></p> <p><i>MERF response indicated recommendation was unwarranted and unnecessary. Recommendation stayed in report with minor change in wording.</i></p> <p><i>Change prompted by MERF response.</i></p>

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	of the Investment Board's changes in operations and procedures regarding the operations of the postretirement investment fund may be the result of legal or administrative interpretations, the responsibility to notify MERF of any such interpretations rests with the State Board of Investment, and the Investment Board should be mandated to communicate those interpretations to MERF.		
	Charging these outlays for administration against Retired Account investment income would provide a more meaningful match of the resources used to generate Retired Account investment income with the income generated by those resources.	Same	<i>Changes not addressed in MERF response.</i>
2DRAFT20	3DRAFT27		
The Retirement Board still must however monitor administrative costs—perhaps more carefully than it has in the past. Recommendations have been presented that would provide more control over these costs.	The Retirement Board still must continually monitor administrative costs.	Same	<i>Change prompted in part by MERF response.</i>
Annual financial audits have concluded that, as a whole, administrative expenses were both reasonable and necessary. On occasion, certain infrequent and immaterial items may have been brought to the attention of the Fund's management.	Annual audits will determine if annual financial reports present a fair accounting of these expenses and whether they have been made in a way which is consistent with the Fund's policies and State law. The Fund's annual financial and compliance audits are performed in accordance with generally accepted auditing standards. Such standards require that audits are planned and performed to obtain reasonable assurance that the financial statements are free of material misstatement. This would include examining, on a test basis, evidence in support of the amounts and disclosures in the financial statements. The results of these tests would appear to indicate that as a whole, administrative expenses typically are properly recorded and classified to permit their fair presentation in the Fund's financial statements. In addition, conclusions that the expenses are sufficiently documented, reasonable, necessary and serving a public purpose appear to have been reached. Items arise	Same	<i>Additional language added to clarify audit work and standards.</i>

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	that may not successfully support these conclusions or stand these tests but experience has shown that these items represent isolated occurrences immaterial to the financial statements.		
	3DRAFT28.1		
	Appointed in 1984.	Appointed in 1984 and served through 1987. Has not served after 1987.	<i>Corrections to table as identified in final MERF board response.</i>
	Appointed in 1984 and is still serving.	Appointed in 1984 and served through January 1989. Has not served since January 1989.	
	Elected again in 1986 and currently serves as a Director.	Elected again in 1986 and served as a Director until March 1989	
2DRAFT22	3DRAFT28.2		
The Executive Director's involvement in and payment by entities in which the Fund has made financial investments raises conflict of interest questions. Whether or not a conflict or potential conflict exists depends primarily on the type of outside entity involved and the extent of the Executive Director's participation.	The Executive Director's involvement in and payment by entities in which the Fund has made financial investments presents several conflict of interest questions. Whether or not a conflict or potential conflict exists is different depending on the type of outside entity involved and the extent of the Executive Director's participation. Our concerns in this area focus on the compensation the Executive Director receives through such participation and the exposure to the Fund created by such involvement.	Same	<i>Change prompted by MERF response.</i>
2DRAFT23	3DRAFT28.3		

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The Executive Director currently receives compensation....	The Executive Director at the time of our study received compensation ....	Same	Change prompted by MERF response.
The Executive Director is on the investment advisory committees for these various limited partnerships.	The Executive Director is on the investment advisory committees for these various limited partnerships, and on the Board of Directors of GRI Corporation at the time of our review.	The Executive Director was on the investment advisory committees for these various limited partnerships and on the Board of Directors of GRI Corp. during the period under review. Previous to the issuance of this report, the Executive Director informed us that he no longer serves on the advisory committees or board of directors of any of the four aforementioned outside entities.	Final change prompted by MERF board response.
The concerns we have regarding participation as a director in a publicly held corporation would not be applicable to these limited partnership involvements.	[DELETED]		
2DRAFT23	3DRAFT28.3		
	The fact that the Executive Director receives sums of money personally, from entities he is charged with evaluating for continued and future investment by the Fund, raises questions as to whether his decisions are being at all influenced by these amounts paid. This is especially true when the total "stipends" in one year could have been \$19,000. The suspicion of undue influence is even true in the area of limited partnerships. As previously discussed, the partnerships involve a specific period of time, and once MERF has committed them, it is difficult to withdraw funds. However, many partnership groups simply form a new partnership when the old one ends. If the Board decides to roll MERF's investment over into the new entity, the	Same	Additional language prompted in part by MERF response.

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	<p>same questions will arise as to whether continued receipt of thousands of dollars per year influenced the Executive Director's recommendation. The suggestion of divided loyalties is no doubt odious to the Board and Executive Director; however, the perception of a conflict of interest will continue as long as dual compensation exists.</p> <p>We are not aware of any statute or law that would forbid this arrangement. We recommend the Board review the propriety of the Executive Director receiving compensation for involvement in organizations in which MERF is invested. The action, however, would create support for the proposition that the Executive Director is acting as the agent of MERF while acting on these outside committees and boards. This is undesirable for reasons set forth in the next section.</p>		
		Same	<i>Additional language prompted in part by MERF response.</i>
The Executive Director's fiduciary duty to protect the assets of the Fund is of paramount concern to us.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
	<p>Separate from the issue of compensation from two sources, is the issue of loyalty owed to each. This issue is especially pronounced in the Executive Director's involvement on the board of directors of GRI Corporation.</p>	Same except added: ...GRI Corporation, on which he served as a director until March 1989.	<i>Final change prompted by MERF board response.</i>
The law imposes several duties on corporate directors which conflict with the Executive Director's primary duties. A corporate director is charged with representing the interests of all shareholders. So it can be seen at the outset that a potential conflict exists between the Executive Director's fiduciary duty to MERF and his duty as a corporate director to all the other shareholders of the corporation.	The law imposes several duties on corporate directors which conflict with the Executive Director's primary duties to MERF. A corporate director is charged with representing the interests of all shareholders. The Executive Director owes all his loyalty to MERF alone. So it can be seen at the outset that a potential conflict exists between the Executive Director's fiduciary duty to MERF and his duty as a corporate director to all the other shareholders of the corporation equally.	Same	<i>Additional language.</i>
...he would be torn by his competing duties to the other shareholders of the corporation arising from his membership on	...he would be torn between his duty to advance the interests of MERF by protecting its assets, and the Federal Securities Laws	Same	<i>Clarifying language.</i>

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the board of directors and his duties to MERF.	that prohibit him from taking any action.		
...sell its corporate interest, he and MERF, as his principal,....	...sell its corporate interests he would be guilty of a Federal crime, and MERF, as his principal....	Same	<i>Clarifying language.</i>
If the Executive Director were to take no action on MERF's part, the Executive Director would violate his duty to protect the assets of the Fund.	If the Executive Director were to take no action on MERF's part, the assets of the Fund will decline in value. The issue here is whether MERF should place its Executive Director in a position in which he would have to break the law in order to do his job.	Same	<i>Change prompted by MERF response.</i>
2DRAFT23,24	3DRAFT28.4		
The Executive Director has joined the board of directors of this corporation at the explicit authorization of the Board, and he is in fact acting as MERF's agent in participating on this Board of Directors. The potential that courts will find MERF liable for the actions of its Executive Director in cases brought by shareholders and other third parties is, under these circumstances very great indeed.	The Executive Director has joined the board of directors of this corporation at the explicit authorization of the Board, and his activities could be viewed as those of MERF's agent in participating on the corporate board. In any action by shareholders, minority shareholders, or third parties against the Executive Director based on his conduct as a member of the board of directors, an attempt will be made to characterize the Executive Director as an agent of MERF, and hence make MERF liable for his activities. If the Executive Director's "stipend" for participation in fact goes to MERF, it would constitute further proof of the Executive Director's agency role, and hence MERF's direct liability.	Same	<i>Change prompted by MERF response.</i>
The trend in the legal system at the present time is to find that where there is control there is responsibility and hence liability. In order to stay free of shareholder and other third party claims, MERF must not in any way participate in the control of publicly held corporations.			
The area of corporate director liability to shareholders and other third parties affected by their corporate decisions is exploding with litigation. There are multiple theories of liability that would hold both the Executive Director and MERF liable for breaches of fiduciary duty and insider trading. In our opinion the risk to the assets of the Fund greatly overshadows the potential benefits of this arrangement.	MERF's purpose in authorizing the Executive Director to participate in corporate boards and investment committees is to provide additional oversight for the Fund's investments. MERF has indicated several specific examples in which the Executive Director's involvement was instrumental in saving large amounts of money for all shareholders, including MERF. MERF views its approach as part of a national trend in which pension funds are responsibly seeking an active role in the corporations in which they invest. MERF argues that no conflict of loyalties exists because MERF's interest as a corporate shareholder is exactly the same as the other shareho'	Same	<i>Change prompted by MERF response.</i>
With regard to the participation in limited partnerships, once the partnership is fr 1 there appears to be no conflict of interest			



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<p>in participating in the Partnership's Investment Advisory Committee. However, since many of these partnership groups simply form a new partnership when an old one ends, the fact that the Executive Director receives several thousand dollars per year from the partnership creates the appearance of a conflict of interest should the Fund decide to roll its investment over into the newly formed partnership.</p> <p>We recommend that the Executive Director be prohibited from acting as a director for any publicly held corporation in which the Fund has investments. Further, we recommend the Board not place the Executive Director in situations where there is a potential for or appearance of a conflict of interest with regard to limited partnership interests. Both of these recommendations could be accomplished by revoking the authorization granted at the July 17, 1984 Board meeting.</p> <p>2DRAFT24</p> <p>Based on the descriptions of the items received, these gifts had no material value.</p> <p>2DRAFT 24</p> <p>At this time we should point out that the Retirement Board has not established a formal code of conduct policy. We recommend that the Board consider adopting a formal code of conduct policy and that it be communicated to all the Board's employees. A code of conduct policy should consider the following broad topics:</p> <ul style="list-style-type: none"> <li>— Conflict of interest;</li> <li>— Devotion of time and ability to the business of the Fund;</li> <li>— Safeguarding of confidential information;</li> <li>— Acceptance of gifts and gratuities;</li> <li>— Safeguarding of the Fund's property;</li> </ul>	<p>We recommend that the Board re-examine the authorization given to the Executive Director and determine whether the advantages from such an arrangement outweigh the appearance of conflict of interest and potential liability on the part of the Fund.</p> <p>3DRAFT 28.5</p> <p>These items were described to us as packets of wild rice, cranberries or a box of chocolates. Based on the descriptions of the items received, we believe these gifts had no material value.</p> <p>3DRAFT28.5</p> <p>[DELETED]</p>	<p>Same</p> <p>Same</p> <p>Same</p>	<p><i>Change prompted by MERF response.</i></p> <p><i>Clarifying language.</i></p>

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--- Disclosure of economic interest.			
We believe that all Board members and their employees should sign an annual confirmation that they have read and understand the code of conduct policy and that they are not aware of any violations of this policy. Such confirmation should remain on file at the Fund's office.	[DELETED]	Same	Change prompted by MERF response.
2DRAFT31	3DRAFT28.11		
Whether the Executive Director's involvement in these outside activities is a conflict of interest or poses the potential for a conflict of interest depends primarily of the type of outside entity involved and the extent of the Executive Director's participation.	[DELETED]	Same	Change prompted by MERF response.
The Executive Director's fiduciary responsibility to protect the assets of the Fund is of paramount concern. The law imposes several fiduciary duties on corporate directors which may conflict with the Executive Director's primary duties. A situation in which the Executive Director's multiple fiduciary duties would clash is easily envisioned. Also, when the Executive Director has joined the board of directors of a corporation at the authorization of the Retirement Board, he is acting as MERF's agent and the potential for third party liability exists. In our opinion, the risk to the assets of the Fund overshadows the potential benefits of this arrangement.	The Executive Director's involvement in and payment by entities in which the Fund has made financial investments presents several conflict of interest questions. Our concerns focus on the compensation the Executive Director receives through such participation and the exposure to the Fund by such involvement. The fact that the Executive Director receives sums of money personally, from the entities he is charged with evaluating for continued and future investment by the Fund, raises questions as to whether his decisions are being at all influenced by these amounts paid. Separate from the issue of compensation from two sources, is the issue of loyalty owed to each. The law imposes several duties on corporate directors which conflict with the Executive Director's primary duties to MERF. The Executive Director had joined the board of directors of a corporation at the explicit authorization of the Retirement Board, and his activities could be viewed as those of MERF's agent in participating on this corporate board. The Executive Director should not be placed in a position where in order to advance MERF's interest he would have to violate the Securities Law.	Same	Change prompted by MERF response.
To protect the assets of the Fund, we have recommended that the Executive Director be prohibited from acting as a director for any publicly held corporation in which the Fund has investments and that the Retirement Board should not place the Executive Director in situations where there is a potential for or appearance of a conflict of interest with regard to limited partnership interests. We also recommend that the Retirement Board establish a formal code of conduct policy.			

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	MERF's purpose in authorizing the Executive Director to participate in corporate boards and investment committees is to provide additional oversight for the Fund's investments. MERF has indicated several specific examples in which the Executive Director's involvement was instrumental in saving large amounts of money for all shareholders, including MERF. MERF views its approach as part of a national trend in which pension funds are responsibly seeking an active role in the corporations in which they invest. MERF argues that no conflict of loyalties exists because MERF's interest as a corporate shareholder is exactly the same as other shareholders.	Same	<i>Change prompted by MERF response.</i>
	We recommend that the Board re-examine the authorization given to the Executive Director and determine whether the advantages from such an arrangement outweigh the appearance of conflict of interest and potential liability on the part of the Fund.	Same	<i>Change prompted by MERF response.</i>
2DRAFT184	3DRAFT29		
Concerns have risen that the Fund ....	Senator Moe had questioned whether the fund....	Same	<i>Change prompted by MERF response.</i>
Between July 1984 and October 1985, MERF provided a wills preparation program for its retirees. Concerns have risen that though the service may be valuable, its cost may have been excessive and, arguably, not part of the assigned duties of the Retirement Board.	Between July 1984 and October 1985, at a cost of approximately \$8,849, MERF provided a wills preparation program for its retirees. In regards to the wills preparation program, Senator Moe inquired as to (1) the amount directly expended on the program, (2) whether MERF had the legal authority to undertake this service and (3) whether any expenditures for this service were paid as administrative expenses.	Same	<i>Change prompted by MERF response.</i>
The key issue is whether the Retirement Board acted appropriately when it provided these programs to its members.	Senator Moe's general question is whether MERF inappropriately provided special services or benefits for its members.	Same	<i>Change prompted by MERF response.</i>
2DRAFT186	3DRAFT31		
Because the Fund's mortgage investments are valued at par rather than market, which is not unusual for this type of invest-	The Fund's mortgage investments are valued at par rather than market, which is not unusual for this type of investment.	Same	<i>Change prompted by MERF response.</i>

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ment, it is difficult to judge whether the investments in mortgages are producing returns comparable to other Fund investments.			
<p>As part of this study, we contacted the State Board of Investment to determine the yield on 10 and 20 year U.S. Treasury securities at approximately the times when the Retirement Board made the separate \$10,000,000 commitments to the mortgage lending program. On august 31, 1985, yields on 10 and 20 year Treasury securities were 9.93 percent and 10.40 percent, respectively. On October 31, 1985, yields on 10 and 20 year Treasury securities were 9.93 and 10.40 percent, respectively. Treasury securities would be an alternative consistent with the investment policies of the Retired Account. The yields available on the Treasury securities do not appear to differ materially from the 10.5 percent interest rate on the mortgages, though servicing costs probably would have the effect of lowering the yield on the mortgages. Aspects of loan servicing are discussed in greater detail in our examination of the operations of MERFCO.</p>	[DELETED]	Same	Change prompted by MERF response.
<p>It is difficult to judge whether the investments in these mortgages are producing returns comparable to other Fund investments because the investments in mortgages are valued at par rather than market. Yields available on U. S. Treasury securities at the times the Retirement Board made the two \$10,000,000 commitments to the program did not appear to differ materially from the 10.5 percent interest rate on the mortgages.</p>	<p>The bi-weekly program was set up as an investment and as a cash flow tool for the Fund. Mortgages present an attractive stream of steady cash flows that are in turn re-invested or are used to meet benefit obligation payments without the risk of capital loss inherent in holding government bonds or other interest bearing securities which may have to be liquidated under some circumstances to meet payments.</p>	Same	Verbatim change taken from MERF response.
	<p>The investments in mortgages are valued at par rather than market. We are not in a position to judge whether the Fund could have done just as well with alternative investment vehicles. This is a matter upon which reasonable, prudent persons may differ in the management of the sums for which they have fiduciary responsibility.</p>	Same	Change prompted by MERF response.

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...amounted to approximately \$8,849.	...amounted to approximately \$8,849 between July 1984 and October 1985.	Same	<i>Added clarifying language.</i>
<p>However, it should have become clear to the Board that at some point the costs associated with providing this service were perhaps going to exceed or perhaps had already exceeded the value that this service was providing not only to those participating in the program, but to the Fund as well. At that point, the Retirement Board should have discontinued the program and informed the participants that this service could no longer be continued due to the unforeseen added administrative costs. We believe the added costs were incurred because the Board did not monitor the costs of this program effectively.</p> <p>Throughout this report, we have made recommendations that will allow the Retirement Board to monitor the Fund's administrative costs more effectively.</p>	The Board believes the act of providing this service to members was not imprudent and the costs were not excessive.	Same	<i>Verbatim change taken from MERF response.</i>
2DRAFT189	3DRAFT34		
Had the Board monitored the costs of this program effectively it would have been clear to the Board that the costs of providing this service perhaps were exceeding the value that this program was providing the Fund.	The costs of printing mailings and forms, and the costs associated with the services provided by the individuals employed on a part-time basis amounted to approximately \$8,849 between July 1984 and October 1985. All costs of this program were paid as administrative expense.	Same	<i>Change prompted by MERF response.</i>
	The Retirement Board has the general authority to administer the Fund and its duties are to provide for and administer retirement benefits. The Retirement Board believed sponsoring a limited-duration wills preparation program conducted by current in-house staff was a reasonable measure to improve the service to plan participants. The Board believes the act of providing this service to members was not imprudent and the costs were not excessive.	Same	<i>Change prompted by MERF response.</i>
2DRAFT32	3DRAFT35		

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
Concerns have arisen .....	Senator Moe was concerned ....	Same	<i>Change prompted by MERF response.</i>
2DRAFT39	3DRAFT42		
As there appears to be no other statutory reference to, or regulation of the Association, questions have been raised as to whether ....	According to Senator Moe, there is no other statutory reference to, or regulation of the Association. He questions whether ....	Same	<i>Change prompted by MERF response.</i>
2DRAFT43	3DRAFT46		
Though there would appear to be many close ties between MERF and the Association, .....	[DELETED]	Same	<i>Not specifically addressed in MERF response.</i>
2DRAFT61	3DRAFT64		
Payment by the Fund of such items does not promote a proper attitude of responsibility on behalf of the Fund's employees. The practice of the Fund's paying parking violations for the Fund's Executive Director should be discontinued. During fiscal year 1987, the Fund also paid for the Executive Director's lifetime membership in the Northwest Airlines Top-Flight Club, which provides travel-related services and benefits including meeting and conference rooms at main Northwest Airlines hubs. It is not clear whether the services and benefits provided by such a membership are commensurate with its cost of \$750.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
2DRAFT61	3DRAFT64		
Because the City of Minneapolis does not exercise oversight responsibility over the Fund, MERF's governing statutes give the Retirement Board broad discretion in determining what constitutes reasonable, necessary and proper expense reimbursements.	[DELETED]	Same	<i>Change prompted by MERF response.</i>

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
We recommend that the Retirement Board expand more fully on the existing policies developed for the payment of expense reimbursement. We also recommend that the Retirement Board develop a procedure whereby the Board would independently verify expense reimbursements. Such method of independent verification could include Board members, on a rotational basis, reviewing the documentation in support of expense reimbursements.			
2DRAFT75	3DRAFT78		
Questions have been raised as to whether....	Senator Moe questioned whether....	Same	Change prompted by MERF response.
2DRAFT75	3DRAFT78		
Though the City of Minneapolis is the predominant employer group covered under MERF's retirement plan, the City does not exercise oversight responsibility over the Fund.	[DELETED]	Same	Change prompted by MERF response.
2DRAFT76	3DRAFT76		
Opportunities have been identified that would enable the Retirement Board to exhibit a greater degree of control over such discretionary costs. These opportunities include the Board expanding on its existing expense reimbursement policies and the development of a method of independent verification of expense reimbursements.	[DELETED]	Same	Change prompted by MERF response.
2DRAFT77	3DRAFT80		
MERF Board members and employees regularly attend.....	MERF Board members and employees attend....	Same	Clarifying language.
2DRAFT83 #section 5 - footnote	3DRAFT86 #Section 5 footnote		
It would appear that the traveler may be due....	It would appear that the Executive Director may be due.....	Same	Change prompted by MERF response.
2DRAFT109	3DRAFT112		

# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

#### Analysis of Changes to Draft Report

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
There were some instances of noncompliance with the travel policy which were identified....	The following exceptions were identified....	Same	<i>Not specifically prompted by MERF.</i>
2DRAFT110	3DRAFT113		
The locations at which these conferences are held typically command premiums for airfare. Often conferees are given choices for lodging by the organization sponsoring the conference, but the convenient locations offered also command premiums.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
We believe however, that the Retirement Board should limit the number attending each of these nationwide conferences. The members attending these conferences should report back to the full Board the topics discussed.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
2DRAFT111,112	3DRAFT114		
...negotiation and legal fees.	...negotiation and legal fees, and is exactly the same requirement as that imposed by every other major institutional lender and is standard throughout the banking and institutional lender industry. The Retirement Board believes it has a fiduciary responsibility to MERF beneficiaries to minimize the cost to the Fund for investigating investments.	Same	<i>Verbatim change taken from MERF response.</i>
It is clear that MERF Board members and employees travel frequently to pension and investment related conferences and meetings.	[DELETED]	Same	<i>Change prompted by MERF response.</i>
During the Fund's annual audits the conclusion was reached that the travel policy adopted by the Board was being materially adhered to though some instances of noncompliance were identified.	During the Fund's annual audits the conclusion was reached that the travel policy adopted by the Board was being materially adhered to.	Same	<i>Change prompted by MERF response.</i>
Whether each instance of Board member or employee travel was necessary is a matter of judgment for the Board, though we believe there are opportunities that exist that would enable the Board to	Whether each instance of Board member or employee travel was necessary is a matter of judgment for the Board.	Same	<i>Change prompted by MERF response.</i>



# Appendix C

## Special Review: Minneapolis Employees Retirement Fund

### MERF Management Study

### Analysis of Changes to Draft Report

	ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
	provide greater control over travel costs:			
	The Board should reconsider the blanket authority allowing the Executive Director and board members to decide for themselves when it is appropriate to attend conferences and seminars that are in the interest of the Fund. The Board should establish a written policy calling for formal authorization in Board minutes of all out-of-state travel by Board members and employees and each trip taken should be authorized in advance.	[DELETED]	Same	Change prompted by MERF response.
	The Board should limit the members attending conferences and seminars and require those who do attend to disseminate the information gained by them, which is beneficial to the Fund.	[DELETED]	Same	Change prompted by MERF response.
103	The Retirement Board should also document the policy or practice it has adopted relative to its position that required potential investment partners cover the Fund's costs and out-of-pocket costs of Board member and employee travel and other related expenses necessary for inspection, negotiation, and legal fees. Such a documented policy would provide indication that the investment decision making process is not being compromised by the Fund's acceptance of these expense reimbursements or other costs covered by the investment partner.	The Retirement Board believes its policy requiring potential investment partners cover the Fund's costs and out-of-pocket costs of Board member and employee travel and other related expenses necessary for inspection, negotiation, and legal fees is no different from the policy of most other major investment institutions and is a standard throughout the banking and institutional lender industry. The Board should put its policy in writing. The Retirement Board believes it has a fiduciary responsibility to MERF beneficiaries to minimize cost to the Fund for investigating investments.	Same	Change prompted by MERF response. Portions taken verbatim from response.
	2DRAFT113	3DRAFT116		
	... could result in savings of about....	... could result in increased revenues of about ....	Same	Added clarifying language.
	2DRAFT116	3DRAFT119		
	It has been suggested....	Senator Moe's November 6, 1987 letter cited a Legislative Auditor's Program Evaluation Division report covering the years 1980 to 1985 which suggested....	Same	Change prompted by MERF response.
	2DRAFT157	3DRAFT160		

**Appendix C**  
**Special Review: Minneapolis Employees Retirement Fund**  
**MERF Management Study**  
**Analysis of Changes to Draft Report**

ORIGINAL DRAFT	REVISED DRAFT	FINAL REPORT	COMMENTS
...annual report indicated separately the purchases and sales of investments from the....	...annual report indicated by broad investment type (e.g. short-term cash equivalents, bonds, common stock, etc. ) the purchases and sales if investments separately for the....	Same	Change prompted by MERF response.

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May 2, 1994

Mr. James R. Nobles  
Legislative Auditor  
Centennial Office Building  
658 Cedar Street  
St. Paul, MN 55155

Dear Mr. Nobles:

Thank you for providing us with a copy of the Report resulting from your special review of certain issues relating to the Minneapolis Employees Retirement Fund ("MERF"). As counsel to MERF, I have reviewed the Report with MERF's Board President, James Lind, and its Executive Director, James Hacking. In this letter, I will provide our collective comments on Chapter 2: Oversight by the MERF Board.

1. In general, we disagree with the statement in the Chapter Conclusions (p. 7) that Mr. Chenoweth dominated the MERF Board and in Finding 1 (p. 8) that Board members were reluctant to challenge his judgment. As your Report indicates, the MERF Board forced Mr. Chenoweth to sell the Jaguar, confronted him with allegations of potential drug use, insisted on the 1989 Management Study and portfolio review by Dr. Heino Beckmann being undertaken, challenged him about sitting on outside boards, and ultimately terminated him.

2. There are references to the Board "accepting Mr. Chenoweth's resignation" on May 11, 1990 (pp. 7, 21). Technically, it is true that the form which the motion took was that of accepting a previously tendered "resignation" by Mr. Chenoweth of his Executive Director (but not his Chief Investment Officer) duties. However, this doesn't begin to describe the actual situation as related by several of the Board members in their interviews with your office, and as is evident from a transcript of the May 11, 1990 meeting. It is quite clear that (a) Mr. Chenoweth had no intention of resigning, and certainly not from his position as Chief Investment Officer; (b) he was shocked and angered at the May 11, 1990 Board

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Mr. James R. Nobles  
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meeting when he was voted out of all positions with MERF; and (c) he stormed out and left that very day. In short, the Board fired Mr. Chenoweth; he did not voluntarily resign.

3. The Report accurately notes that Mr. Chenoweth "was not completely truthful" and "did not keep the Board fully informed." (Transmittal Letter,<sup>1/</sup> p. 2; Report, p. 7, Chapter Conclusions; Report, p. 8, Finding 1.) However, this does not go far enough. Mr. Chenoweth, indeed, actively concealed information from the Board. It was this pattern of conduct which made it difficult, if not impossible, for the Board, in spite of its best efforts, to "fully exercise the oversight responsibilities established in its investment policy." (Finding 2, Report, p. 10; Transmittal Letter, p. 3.)

4. Certain statements under Finding 2 (p. 10) leave an incorrect impression. For example, the statement that nothing showed that the Board "monitored markets, set asset allocation targets, or reallocated in-house assets to comply with the policy" fails to recognize the fact that the Board relied upon both Mr. Chenoweth and outside advisors (Standard Valuations and Performance Analytics) regarding such matters. (Also, as part of the 1989 Management Study, Dr. Beckmann looked at these issues and found no fault.)

5. The Report (p. 11) identifies certain investments which the Legislative Auditor believes to be inconsistent with the allocation guidelines of MERF's investment policy. We submit that none of these involved any actual violation of the policy. Even the second bullet point (p. 11), noting that mortgage investments exceeded 20% of the Retired Fund, does not show any inconsistency with the guidelines. First, any violation would have to be considered minor and technical (except for one quarter during the period in question, 1986-1988, MERF's mortgage investments were only a few percentage points over 20%), and there was no violation of the governing statutes. Second, although the Legislative Auditor interprets the investment policy as limiting MERF's mortgage investments to 20% of the Retired Fund, such a limitation is not evident from the language of the policy. See Table 2-1 (p. 10). Indeed, mortgage investments are simply one component of fixed income investments, which the policy indicates may total 20-60% of the Retired Fund.

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<sup>1/</sup> Refers to the four-page transmittal letter from Messrs. Nobles and Asmussen to Senator Riveness.

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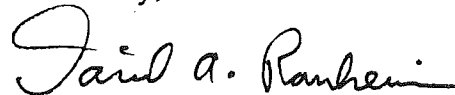
6. To be fair, it should be noted that of the four items identified as possible illegal or improper conduct by Mr. Chenoweth during his MERF employment (pp. 7, 13), two came to the Board's attention just prior to his termination: Chenoweth's board memberships and his efforts to remove two MERF Board members. As to the former, the Report (pp. 18-19) correctly notes that in December 1988 Mr. Chenoweth advised the Board that he was resigning such positions; the Board did not learn otherwise until March 1990. It was these and other revelations that contributed to the erosion of Mr. Chenoweth's support with the Board.

7. It doesn't go quite far enough to suggest that at the end of the December 30, 1988 meeting regarding the drug use allegations, "the Board accepted Mr. Chenoweth's explanations" (p. 15). It was not so much a matter of accepting his explanations, as believing that there was not sufficient evidence to conclude that he was involved in such activities since there were no witnesses.

Finally, the transmittal letter to Senator Riveness (p. 3) notes certain items that it would have been beneficial to have had in place during the time in question. As reflected in the attachment to this letter, you will see that MERF now has in place virtually all of the items noted, plus some. Thus, while the scope of your work did not include making official recommendations about the "tools and techniques" to be used to avoid future problems, the readers of your Report should be assured that, indeed, the problems have been addressed and changes have been made to protect as much as possible against their happening again.

Thank you for the opportunity to comment on the Report.

Sincerely,



David A. Ranheim

DAR:sl  
Attachment

## **ACTIONS TAKEN TO STRENGTHEN INTERNAL OVERSIGHT**

Among the many things that have been done by statute, internal MERF policies and administrative restructuring to prevent the types of abuses that occurred during the latter years of John Chenoweth's tenure as MERF Director, the following should be noted:

- All assets of the Fund (both money and property) have been outsourced and are managed by an entirely new team of external professional asset managers; in-house asset management has been specifically prohibited by law.
- All members of the Board and those authorized to manage or invest MERF assets are subject to the fiduciary responsibility rules contained in Chapter 356A, of state statutes.
- All MERF assets must be managed as provided in Section 11A.24 (the same rules as govern the State Board of Investment).
- A comprehensive set of investment policies has been adopted that includes specific benchmarks for evaluating performance of the MERF funds, asset classes and individual managers.
- All members of the MERF Board and staff are required to file annual statements of *Economic Interest* (as prescribed in Section 356A.06, subd. 4); in addition, all MERF staff members provide to the Board a list of all securities they own personally or through members of their families;
- MERF policies contain a list of requirements, disclosures and prohibitions designed to preclude actual or potential conflicts of interest.
- MERF has proposed, and will create (by statute or administrative action) an investment panel (all fiduciaries) that will consist of the City's Director of Finance, the School District's Superintendent or designate, the Mn. Commissioner of Finance or his designate and at least two persons appointed by the Board who, by academic training/experience are experts in the field of investment/finance; all investment-related issues are to be decided first by the panel and then referred on (with recommendation) to the Board for ultimate decision-making.
- The Board has, under contract, an independent consultant (Bankers Trust Co.) that reports quarterly to the Board the performance of the Fund, asset classes and managers, relative to their assigned benchmarks and "peer group;" in addition, the Board has, under contract, an independent investment consultant who reviews all investment-related matters and makes recommendations.
- The MERF Board meets as a committee of-the-whole to review annual financial audits and any special studies; quarterly, MERF Board members, staff and investment consultant meet with asset managers to discuss performance.

- All MERF Board meetings are subject to the open meeting rules and are recorded; minutes are kept and all written resolutions, legal opinions or other documents are made part of the MERF public record and are available for inspection or photocopying.
- All MERF staff, including the Director, have their performance reviewed on an annual basis; all positions are governed by Civil Service rules and have specific position descriptions assigned that include standards to be applied in the evaluation of performance.
- MERF internal policies require submission to the Board of a variety of investment- related reports that are designed to provide comprehensive and complete disclosure.

## **Special Review: Minneapolis Employees Retirement Fund**

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May 2, 1994

Mr. James R. Nobles  
Legislative Auditor  
Office of the Legislative Auditor  
Centennial Building  
St. Paul, Minnesota 55155

Re: Minneapolis Employees Retirement Fund

Dear Mr. Nobles:

On behalf of our client, former State Auditor Arne Carlson, we thank you for submitting to us for review the Legislative Auditor's "Special Review of Selected Issues Relating to Oversight of the Minneapolis Employees Retirement Fund."

We commend you and your staff for your objective analysis of these issues, especially in the wake of the many incorrect and unsubstantiated conclusions and aspersions made by the Star Tribune and other partisans.

We are pleased that you have confirmed that the Office of State Auditor reviewed information about potential improper activities by John Chenoweth in accordance with established office policies; that there was no independence impairment that inhibited State Auditor staff to appropriately conduct MERF audits; that there was no evidence of a personal friendship or social relationship between John Chenoweth and Arne Carlson; that there was no evidence that the State Auditor placed restrictions on the scope of MERF audits; and that changes to audit reports were not the result of an alleged cover-up by the Office of State Auditor to protect MERF.

We have only a few other comments on selected report sections.

1. The Legislature's Role.

While we acknowledge the Legislative Auditor's conflict of interest in analyzing the Legislature's role with respect to MERF problems, we find it unfortunate that that analysis

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could not be completed and released together with your report so that the roles of all parties involved with MERF could be evaluated together. We look forward to release of the special examiner's report concerning the Legislature's involvement with MERF.

2. The MERF Board.

We believe that your report unduly downplays the MERF Board's role in failing to prevent MERF investment losses. The sole fiduciary responsibilities for MERF investments, of course, rested with that Board and its executive director. While the MERF Board may have responded appropriately to specific incidents of alleged misconduct, such as the Jaguar purchase or allegations of drug abuse, the fact remains that the Board was asleep at the controls while imprudent investments were made and held by its executive director. No doubt, Mr. Chenoweth withheld information and misled the Board, but the Board failed to fulfill its responsibility to demand and obtain investment background and performance information. These failures include the lackadaisical approach to MERF business by some Board members who most often did not even attend Board meetings.

3. Changes in the Management Study.

The changes in the 1989 Management Study have been the subject of much media attention and speculation. We are gratified that you have found, as we have maintained throughout these proceedings, that there was "no pressure or inappropriate influence by State Auditor Carlson to change the report to accommodate MERF." We commend you for the most thorough analysis of these changes to date. Virtually all of the changes to the draft report prompted by the MERF response were inconsequential, were necessary to correct or clarify facts, identified MERF's position on issues, or simply changed subjective comments to objective statements. The final report accomplished the Office of the State Auditor's understanding of the report's goal: to provide an objective study of specific issues that had been identified as potential problems by oversight officials.

With respect to the issues specifically addressed in your report, the changes to the Management Study did not remove any important information, but followed an objective approach to these issues. For example, the conflict of

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interest issue was thoroughly discussed in the Management Study over MERF's objection. The study clearly identified problems caused by the executive director's service for compensation on boards of companies in which MERF had invested, including the conflict of interest issue and whether MERF could be liable as a principal for alleged misconduct by its executive director on the other boards. The issues were discussed in detail, and MERF was urged to reexamine the propriety of its policy allowing and even encouraging board membership.

Other issues you examined, including the application of State Board of Investment procedures to MERF, and travel expense policies, were also thoroughly discussed in the report. Certainly, sufficient information was provided to permit informed public policy judgments on these issues. The recommendation for a formal code-of-conduct policy was removed because enactment in 1989 of the Public Pension Fiduciary Responsibility Act obviated the need for such a policy.

We acknowledge that subjective comments on a handful of issues were changed in the report. The objective approach embodied in the changes, however, certainly provided adequate information to policymakers, such as Senator Moe and the Legislative Commission on Pensions and Retirement, to make policy decisions. The State Auditor's Office also cannot be faulted for failing to meet expectations of MERF Board or legislative staff members of which the Auditor's Office was not made aware.

Star Tribune and legislative comments have always presumed that changes to the Management Study were not only ill-intentioned, but also significant in affecting MERF fund performance. While you have not addressed this issue, the changes simply could not have affected investment performance. Because the Management Study by design addressed a group of narrow, specific issues, the report, even if issued in its draft form unchanged by MERF response, would not have staved off the losses sustained by MERF soon thereafter.

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4. Investment Verifications.

With focused hindsight, sharpened by years of expensive litigation and public scrutiny, no doubt an auditor could conclude that any late-1980s audit should have tested additional asset valuations. Your conclusion that "the Auditors could have done more to test the market value of MERF investments" thus must be considered in context. At the time, there was little or no evidence of permanent impairment of MERF assets. Prior audits had confirmed the reliability of asset valuations in MERF financial statements. Auditor Fritsch monitored the investment portfolio for valuation and appropriately noted in 1989 that the fund was becoming increasingly speculative and required close scrutiny in future audits.

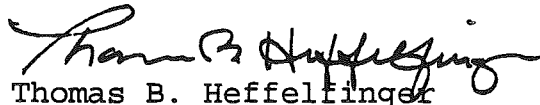
Purchase of many of the speculative investments did not occur until 1988 or 1989, and evidence as to their difficulties did not surface until after the 1989 audit. Moreover, the 1989 audit was completed after purchase of all of the troubled assets and after John Chenoweth's departure from MERF. Therefore, additional asset valuation activities during the 1989 audit probably would not have prevented any investment losses.

Respectfully yours,

BOWMAN AND BROOKE



George W. Soule



Thomas B. Heffelfinger

Attorneys for former State  
Auditor Arne Carlson

GWS:lj