Forensic Investigation of the Jacksonville Police and Fire Pension Fund

Report to Jacksonville City Council by Benchmark Financial Services, Inc., October 28, 2015

Forensic Investigation of the Jacksonville Police and Fire Pension Fund

- **Key Findings:**

1. The lack of transparency of the pension fund Board of Trustees generally and in connection with this investigation amounts to a profound "red flag."
2. City Council may ask Florida Governor Scott to reconsider investigating the pension due to statewide and national concerns raised in this report.
3. Federal Bureau of Investigation and U.S. Securities and Exchange Commission assistance may be advisable.
4. City Council should immediately subpoena information requested over the course of this investigation that the Board has failed to provide.
5. Board has failed to obtain insurance to protect pension from Board errors and omissions, as well as fidelity bond coverage to protect against fraud or dishonest acts by Board or staff. The Board has used plan assets for its own legal defense, as opposed to being used for the exclusive benefit of participants and beneficiaries—in violation of Employee Retirement Income Security Act (ERISA) fiduciary standards.
6. Board, staff and vendors may be subject to **personal liability** for any ERISA fiduciary breaches since pension adopted heightened ERISA fiduciary standards for Board, staff and all vendors.
7. Board has failed to provide oversight to ensure compliance with heightened ERISA fiduciary standards. Many contracts between Board, money managers and other vendors handling pension assets, as well as their business practices, do not comply with ERISA.

8. Board poor investment decision-making has resulted in at least **$370 million in underperformance losses.**
9. Board failure to scrutinize investment management fees has resulted in excess fees of **$6 million** annually or **$36 million** over the past six years.
10. Board failed to provide information that was repeatedly requested regarding an estimated **$5.7 million** in "commission rebates" and related expenditures—information required to identify whether there has been any potential embezzlement or misuse of such pension assets.
11. Board's recent **$27 million loss** in Energy Master Limited Partnerships was imprudent due to lack of diversification, lack of transparency, and high fees—an avoidable loss.
12. Board failed to heed credible warnings of conflicts of interest at former investment consultant, eventually settling with firm for **$273,696** without analysis or evaluation of any harm caused to the pension. Such conflicts (according to a U.S. Government Accountability Office analysis) may have cost the pension almost **30 percent** of its value—**$300- $500 million** over two decades.
13. Board failed to diligently monitor and record pension investment performance which necessitates corrective action and accurate reporting of true past pension performance to all stakeholders.
14. Board failed to scrutinize conflicts of interest related to, and compensation disclosed, as well as received, by its General Counsel and other law firms. City may seek assistance from the Florida Bar and U.S. Department of Justice.
15. Board-approved senior staff pension plan was deemed illegal by City General Counsel, and that plan may also fail to meet heightened ERISA fiduciary standards.
16. Allegations of waste, abuse and ethics violations regarding Board and staff travel should be resolved by limiting frequency, purpose and range of travel.

I. Executive Summary

The City of Jacksonville Police and Fire Pension Fund, with assets of approximately $1.43 billion, has long been surrounded by controversy. City leaders have debated reform of the Fund since at least 2008 when Florida TaxWatch, a nonprofit government watchdog group, raised alarms because the pension's unfunded liability was about $798 million at the time. According to Florida TaxWatch, today the unfunded liability "stands at over $1.65 billion."

The Fund's funded ratio dropped from 87 percent in 2000 to 39 percent in 2013—the lowest and most precipitous drop in funded ratio for any of Florida's large cities.

For years, residents have called for a forensic audit of the Fund to determine whether the pension violated any state laws or rules, largely due to a series of investigations by The Florida Times-Union which "created an appearance of impropriety and raised issues of questionable practices and leadership." Florida Governor Rick Scott was asked to authorize a state investigation of the Fund, as well as to specifically investigate a special pension plan the Board of the Fund created for senior staff members, including John Keane (the longtime executive director)—a plan that the City's General Counsel deemed illegal.

The Governor chose to stay out of the pension issues in Jacksonville, noting that such "concerns would be more appropriately handled at the local level." Any specific criminal violations should be referred to local law enforcement or the state attorney's office, said Scott.

The Jacksonville City Council unanimously voted on April 28, 2015 to hire Benchmark Financial Services, Inc. ("Benchmark") to provide an expert forensic review of the Fund. On June 24, 2015, Benchmark was contractually engaged by the City Council.

- **Limitations on Investigation**

We note with great emphasis that this investigation was conducted without the power to compel the Board of Trustees of the Fund, staff or others to comply with state disclosure laws or provide the information we requested. As discussed with the Board Chair and noted throughout the report, the Fund Administrator and other pension fiduciaries failed to provide a great deal of the information we requested—including key documents that we have been told do, in fact, exist.

For example, the Fund Administrator repeatedly represented to us—contrary to written representations by the General Counsel of the Fund to the Board—that no portfolio monitoring agreement ever existed between the Fund and the Fund's "primary securities litigation counsel," Bernstein Litowitz Berger & Grossmann.

The Fund Administrator repeatedly claimed to have no documents disclosing the dollar amount of fees the General Counsel actually earned in connection with specific class action litigations the General Counsel recommended the Fund initiate against publicly traded companies—despite the fact that the General Counsel himself stated in a letter to the Board that the final percentage, amounts and names of firms receiving such fees are always reported to the Board.

The historic investment performance information provided to us by the Fund's current investment consultant for the period from 1988 through today was neither prepared, nor confirmed, by the master custodian bank actually holding the assets—the most reliable source for such information.

Worse still, two decades of investment performance information was prepared by a former pension consultant to the Fund who was terminated as a result of an investigation by the United States Securities

and Exchange Commission ("SEC"). The SEC investigation concluded the firm breached its fiduciary duty to its pension clients by misrepresenting and omitting to disclose material information.

We are told the Board neither conducted nor commissioned any meaningful review of the former consultant's work—which included advising on key issues such as asset allocation, money manager selection and investment performance—or potential damages to the Fund resulting from any fiduciary breaches, subsequent to terminating the firm.

In response to our request for verified performance for the twenty-year period, we were told that the master custodian had indicated it could not at this time calculate performance for the period.

The performance information we were provided was clearly inaccurate, at least in part. Upon questioning, the current investment consultant acknowledged obvious inconsistencies in certain of the performance figures.

Any analysis of investment performance data portions of which, at a minimum, are clearly wrong is inherently less reliable.

While we have estimated Fund underperformance losses of approximately **$370 million**, we simply do not know for certain how well, or badly, the Fund's investments have performed over the decades—and, based upon the information we were provided, apparently neither does the Board nor anyone else currently involved with the Fund.

As mentioned above, certain significant information regarding potential conflicts of interest and fees paid by the Fund (directly or indirectly in connection with securities class action litigations), as well as fees paid by

other fiduciaries of the Fund, such as law firms, investment managers and consultants, to the Fund's General Counsel was not provided despite repeated requests.

Information we requested regarding the expenditure of an estimated **$5.7 million** in securities trading commission dollars "rebated" to the Fund was not provided.

We recommend that all information requests by Benchmark related to this investigation, as well as all responses by the Board, Fund Administrator and other plan fiduciaries, be made publicly available so that stakeholders, including pension participants and taxpayers, are able to evaluate for themselves the Fund's level of transparency and the integrity of its operations.

We understand that the City Council is subpoenaing the information which we requested but did not receive. It may be advisable for the City Council to ask the Governor to reconsider an investigation and, at the very least read this report before dismissing the matter as a local issue. In addition, Federal Bureau of Investigation and U.S. Securities and Exchange Commission assistance may be advisable. The Florida Bar and U.S> Department of Justice may also have an interest in certain matters herein.

- **Board Lack of Transparency Amounts to Profound "Red Flag"**

While the Fund's website proclaims that the Board of the Fund supports the Florida "Government in the Sunshine" laws designed to provide transparency and openness in government operations, the Board has repeatedly come under criticism from citizens, media, foundations and City Council members for failing to be responsive to public records requests. Further, the Board has reportedly spent hundreds of

thousands of Fund dollars in litigation related to requests for public records.

In connection with this investigation on behalf of the City Council, although we submitted our first document request on June 29, 2015, not a single record requested was provided to us by the Board or Fund Administrator for almost two months.

It is important to note the following regarding our initial request for documents:

1. Our request was not a "public records" request. It was a request by the City Council for records related to a pension substantially funded by the City.
2. Action by the City's Ethic Director, as reported in The Florida Times Union, immediately preceded and apparently prompted the late response in August to our June records request.
3. As a result of the Times Union article, the Board was on notice of the inadequate response to our requests and should have taken action to ensure complete cooperation with this investigation.
4. The overwhelming majority of the documents requested, such as annual reports and investment performance reports were obviously readily available.

In the context of a forensic investigation into a highly controversial, severely underfunded, underperforming public pension—a very public investigation commissioned by the City Council—the delays, incomplete and inconsistent responses, as well as failures to produce documents we experienced amount to a profound "red flag," in our opinion.

- **Board Failure to Provide Fiduciary Oversight - Delegation of Broad Responsibility to Administrator and Outside General Counsel**

A five-member Board of Pension Trustees has sole responsibility for administering the Fund. The Board provides investment oversight for the management of assets and has adopted a Statement of Investment Policy for the Fund.

As detailed throughout this report, in our opinion, the Board has failed to provide oversight, consistent with its fiduciary duties, with respect to matters as fundamental as verifying, evaluating and reporting investment performance of the Fund over time; investment manager and other vendor compliance with applicable heightened ERISA fiduciary standards adopted by the Fund; monitoring conflicts of interest and establishing corresponding safeguards; and reviewing, as well as assessing, the reasonableness of investment management and other fees paid by the Fund.

The Board delegates responsibilities to the Fund Administrator for the implementation of the Statement of Investment Policy and in the provision of administrative oversight of the investment managers to ensure that the Board's policies are being properly implemented.

On the one hand, the Board has delegated exceptionally broad responsibilities to the Fund Administrator, encompassing various portfolio investment matters. On the other, the Fund Administrator lacks any meaningful investment credentials.

The Board has also delegated broad responsibility to an outside law firm subject to numerous potential conflicts of interest related to matters such as opining as to the legitimacy of a senior staff pension plan fully-funded by the Fund and later deemed illegal by the City General Counsel; splitting fees with class action law firms he recommended to

the Board; receiving sponsorship fees for his annual client conference from other plan fiduciaries; and advice regarding retaining and later suing, as well as settling with, the former investment consultant.

- **Board Lacks Errors and Omissions - Fidelity Bond Insurance**

In response to our inquiry, the Fund Administrator indicated that the Board has no current errors and omissions or fidelity bond insurance coverage. (It is our understanding that the Board of the City of Jacksonville Retirement System also lacks such coverage.)

Currently, the cost of defending legal challenges to the Board's actions, e.g., denial of public records requests and allegedly illegal staff pensions, is paid out of Fund assets (and ultimately by taxpayers and participants) —as opposed to by an insurer. The Fund is also at risk regarding any loss resulting from fraudulent or dishonest acts by the Board or the staff.

The Board has an obligation, as an ERISA fiduciary, to manage the Fund exclusively for the benefit of participants. Opposing public records requests or defending allegedly illegal staff pensions does not, in our opinion, in any way benefit the Fund or its participants. Thus, in our opinion, Fund assets should not be used to defend the Board, staff and others in these matters.

As ERISA fiduciaries, the Board should obtain errors and omissions coverage to protect the Fund against loss resulting from errors or omissions by the Board or staff, in our opinion.

As ERISA fiduciaries, the Board should obtain fidelity bond coverage to protect the Fund against loss resulting from fraudulent or dishonest acts of the Board or staff, in our opinion.

A copy of this report, as well as any complaints filed against the Board or staff should be provided to any potential insurer.

Finally, as discussed below, as ERISA fiduciaries, the Board and staff may be *personally liable* for any past or future breach of fiduciary duty, including use of plan assets for personal benefit.

- **ERISA Fiduciary Standard "Highest Known to the Law" Adopted For Board, Staff and Service Providers**

The Introduction to the Fund's Statement of Investment Policy posted on its website states, "Although the Board of Trustees acknowledges that the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), does not apply to the Fund as a governmental retirement plan, it hereby adopts the fiduciary provisions of ERISA. The Board, the Fund's staff and the Fund's service providers shall discharge their responsibilities in the same manner as if the Fund were governed by the fiduciary responsibility provisions of ERISA."

(The City of Jacksonville Retirement System includes the same language in its Statement of Investment Policy posted on its website.)

The fiduciary duty established under ERISA is recognized as the "highest known to the law."

ERISA strictly prohibits a fiduciary from engaging in a self-dealing transaction that involves plan assets where a conflict of interest exists.

The disclosure of a material conflict, alone, is never sufficient under ERISA's duty of loyalty and self-dealing "prohibited transaction" provisions to avoid a violation of ERISA. Conflicts of interest are by definition contrary to ERISA's fiduciary duty of loyalty and self-dealing prohibited transaction provisions.

Failure to comply with ERISA's fiduciary requirements can result in significant penalties. ERISA provides that a fiduciary is personally liable

in the event of a breach of the fiduciary duty provisions. Furthermore, ERISA provides the fiduciary may have to make good on any losses to the plan caused by the breach and restore any profits gained by the fiduciary in using plan assets to its own benefit.

- **Lack of Compliance with ERISA Fiduciary Standards**

Since the Board has adopted the heightened fiduciary standards of ERISA in the Fund's Statement of Investment Policy posted on its website, stakeholders (including participants and taxpayers) may reasonably assume that the Board has established policies and procedures to ensure compliance with these standards. We found scant evidence of compliance with ERISA fiduciary standards.

In our opinion, it appears ERISA fiduciary compliance has been largely overlooked—despite the fact that these are heightened fiduciary standards, noncompliance can have serious consequences and there is a risk of significant personal liability.

For example, as mentioned below, Board failure to scrutinize investment management fees—as required under ERISA fiduciary standards—we estimate, alone, has resulted **in $6 million** in excessive fees paid each year or **$36 million** over the past six years. The Board's failure to conduct or commission any review of the damage to the Fund caused by its former investment consultant over two decades, choosing instead to accept a settlement of a mere $273,696, for an estimated **$300-$500 million in underperformance losses**, was exponentially costlier.

Our limited review of the investment management agreements and subscription agreements between the Board and its asset managers identified serious apparent ERISA non-compliance.

For example, the Investor Subscription Booklet for the Acadian Emerging Markets Equity II Fund LLC states that if the investor (the Fund) is not

subject to ERISA, the Fund acknowledges that Acadian may enter into certain transactions and represents that those transactions by Acadian will not result in a violation of any law to which the Fund is subject that is similar to the prohibited transaction provisions of ERISA and represents that entering into such transactions is permissible under the governing documents of the Fund.

The Fund Administrator indicated in the Acadian Investor Questionnaire that the Fund was not subject to ERISA.

In short, it appears that Acadian may not be aware of its obligation to manage Fund assets consistent with ERISA fiduciary standards and may not be managing the Fund's assets accordingly. While any such ERISA fiduciary breaches could conceivably give rise to liability for losses, the Fund has agreed to indemnify Acadian for any ERISA fiduciary breaches.

In the Eaton Vance Subscription Documents the Fund represented that it was not subject to the fiduciary responsibility standards and prohibited transaction restrictions of ERISA.

Certain of the practices permitted in the agreement with the Fund's Master Custodian, Northern Trust, appear to be inconsistent with ERISA fiduciary standards. For example, the contract indicates that Northern may deposit cash in any depository including its own banking department, without any liability for the payment of interest thereon and receive "float" income on uninvested cash.

The agreements between the Board and the Board's General Counsel and investment consultant raised additional ERISA fiduciary issues, in our opinion.

We recommend a complete review of the Fund's policies, practices, procedures and agreements for compliance with heightened ERISA fiduciary standards. In the event that the Fund has suffered losses as a

result of breaches of the ERISA fiduciary standard, damages may be recoverable from responsible parties.

- **Controversies Regarding Pension Staff**

Pension staff consists of seven employees. The Executive Director-Administrator of the Fund since 1990 has been John Keane. Most unusual, in addition to his role as Administrator of the Fund, Mr. Keane has been the lead negotiator for police and fire unions in pension reform negotiations.

Mr. Keane has been a controversial figure as a result of his frequent convention travel, over $400,000 in unused vacation pay and "questionable deals for his personally created pension."

On August 29th, Mr. Keane gave three-week notice that he would retire on September 18, 2015. However, at the Board's insistence, he agreed to stay on at the Fund through the end of the month. Most recently, it is our understanding he has been engaged as a consultant to the Fund.

- **General Counsel Potential Conflicts-Compensation Disclosure**

The legal counsel to the Board over the decades has been the Plantation, Florida law firm of Klausner Kaufman Jensen & Levinson. In effect, the Klausner firm acts as the outside General Counsel of the Board, supervising even other attorneys retained by the Board, as well as recommending attorneys and specific litigations. In certain documents Mr. Klausner refers to himself as General Counsel

As ERISA fiduciaries of the Fund, the Board has a duty to review any potential conflicts of interest related to the General Counsel and other law firms providing services to the Fund and all compensation paid to, or received by, these parties related to the Fund for reasonableness. Likewise, as ERSIA fiduciaries, the General Counsel and other law firms

providing services to the Fund have an obligation to disclose any potential conflicts of interest and all compensation they pay, or receive, related to the Fund.

As summarized below and detailed extensively in our report, based upon the limited information eventually provided by the Fund Administrator, it does not appear that the Board has fulfilled its fiduciary duty under ERISA to scrutinize the conflicts related to, and reasonableness of, the compensation paid to, or received by, the General Counsel and other law firms related to the Fund.

In an effort to identify potential conflicts of interest and all sources of compensation, we requested from the Fund Administrator documents reflecting any compensation in any form, direct or indirect, paid by any fiduciary of the Fund to the General Counsel or any related law firm or entity for the past 15 years. If the Fund did not have these documents, we requested that the General Counsel disclose this data to the Fund pursuant to his fiduciary duties and provide us proof of this request and response.

In response, the Fund Administrator provided only payee transaction information indicating that the Fund (no other fiduciary) over the past 10 years (not the 15 requested) paid the General Counsel directly approximately $2.72 million for professional services from October 2004 through August 19, 2015. The General Counsel provided no information to us.

1. *Compensation to General Counsel From Class Action Law Firms*

According to published reports (and the General Counsel himself), in addition to the $2.7 million in fees paid by the Fund to the General Counsel, his firm may have received millions in fees from one or more

securities class action law firms retained by the Fund to pursue litigation related to the Fund's investments.

It is our understanding that the General Counsel:

- Recommends class action law firms to monitor the Fund's investments and pursue litigation related to portfolio securities;
- Advises the Fund when to initiate or participate in a given lawsuit;
- Negotiates (on behalf of the Fund) fees paid to these law firms;
- Enters into fee-splitting arrangements with the firms he recommends for class action litigations whereby his firm receives a portion of the fees related to these cases.

Florida Rules of Professional Conduct applicable to lawyers effectively provide that a division of fees between lawyers who are not in the same firm may only be made pursuant to an agreement that fully discloses that a division of fees will be made and the basis upon which the division of fees will be made.

Any potential violations of such rules regarding full disclosure of fees, including any misrepresentation of fee arrangements by a lawyer should be reported to the appropriate authorities. An apparently isolated violation may indicate a pattern of misconduct that only a disciplinary investigation can uncover and reporting a violation is especially important where the victim is unlikely to discover the offense, according to the Florida Bar.

We note with great emphasis that even if any such fee-splitting arrangements among law firms may be permissible under certain conditions prescribed by laws generally applicable to Florida licensed lawyers, whether the General Counsel, as an ERISA fiduciary to the Fund, may receive such fees and whether the class action firms retained by the

Fund, as ERISA fiduciaries, may pay such fees to the General Counsel in connection with Fund litigation is an entirely separate matter. Any such dealings may amount to "prohibited transactions" under ERISA fiduciary standards and give rise to personal liability.

In general, full disclosure of the potential conflict of interest and amount of any compensation related to a transaction that could be considered fiduciary "self-dealing" under ERISA would be required, at a minimum.

We repeatedly requested the Fund Administrator provide contracts between the Fund and any class action securities law firms for either monitoring or litigation. While the Fund Administrator eventually did provide four portfolio monitoring agreements between the Fund and securities litigation firms, he did not provide any contracts or agreements between the Fund and the BLBG, the Fund's primary securities litigation counsel.

The Fund Administrator repeatedly stated—contrary to written representations by the General Counsel to the Board we reviewed—that no portfolio monitoring agreement ever existed between the Fund and BLBG.

Shortly after a Forbes article that mentioned fees the General Counsel received for referring cases to class action firms, the General Counsel wrote a letter to the Trustees, at the request of the Chairman, to review prior discussions concerning the Fund's role as a lead plaintiff in securities litigation matters.

The September 20, 2004 letter stated that the Board entered into an agreement with BLBG to monitor the Fund's portfolio and that in addition to any contingency fee agreement the Fund might enter into with BLBG, the General Counsel's firm would be paid a fee from any class settlement in which the Fund participated.

If a fee was paid to any law firm, the amount and the names of the payees would be reported in writing to the Board. No fee application or settlement decision would be made without the Board's prior approval. Fees, said the General Counsel, "are usually between 15-18% of the recovery. I usually receive between 5 and 10% of the approved fee. The final percentage and the dollar amount are always reported to the client."

Accordingly, we asked the Fund Administrator to provide the final percentage and dollar amount of all fees received by the General Counsel related to any class action litigation involving the Fund, as disclosed to the Board. If the final percentages and dollar amounts were not disclosed, we asked the Administrator so indicate. We received no response from the Fund Administrator.

While our requests for information regarding compensation to the General Counsel in connection with class action litigations were largely unsuccessful, based upon limited information obtained from alternate sources, we estimate that the General Counsel may have received the following additional compensation:

United Health Group: Assuming the General Counsel received 10 percent of plaintiff's counsel awarded fee of approximately $29 million or $2.9 million, the fees he received from this case alone may exceed total fees of $2.7 million paid directly by the Fund to the General Counsel over the past ten years.

Merrill Lynch: Of the $8.5 million settlement, fees of $2.125 million were awarded. The fees awarded represented 25 percent of the settlement—not the 15-18 percent the General Counsel told the Board usually applied. Assuming the General Counsel received 10 percent of the approved fee, he earned $212,500—nearly as much as the $273,696 the

Fund received from the Merrill settlement fund for harm caused to the Fund.

In connection with an Ernst & Young (Nextcard) settlement, of a $23.2 million offer made in April 2005, the General Counsel stated he would receive 10 percent of the fee ultimately paid to BLBG. Assuming BLBG received a fee of 18 percent and the General Counsel received 10 percent of that fee, the General Counsel may have received $417,600.

We note in this report that other Florida public pension lawyers claim that class action firms routinely offer them 18 percent. If true with respect to the General Counsel, then the total class action fees estimated above may be significantly understated.

It is our understanding that the City Council will subpoena from the General Counsel information regarding all payments to and from his firm and other law firms directly or indirectly related to the Fund. These parties should not object since, according to the documents we have reviewed, they supposedly have already provided all such fee-splitting information to the Board.

We note that the Fund pays the General Counsel $285.00 per hour for his legal services. As ERISA fiduciaries, the Board should examine any differential in the hourly rate he receives in connection with class actions, as well as any percentages in lieu of hourly rates.

2. Compensation From Fund Fiduciaries to General Counsel

According to the same 2004 Forbes article, the General Counsel received additional compensation from law firms (not related to legal services) and other fiduciaries of the Fund, such as investment consultants and investment advisors managing Fund assets.

According to published reports, both BLBG and Merrill Lynch, the Fund's terminated investment consultant, paid to sponsor the General Counsel's annual public pension client conference.

These payments between fiduciaries to the Fund pose a significant potential conflict of interest. For example, in addition to recommending BLBG to the Fund as primary counsel for highly-lucrative securities litigation, the General Counsel advised the Fund on conflicts of interest involving the former investment gatekeeper (Merrill Lynch), as well as the decision to terminate Merrill and later participated in litigation (resulting in fees paid to BLBG and his own firm) against Merrill.

We also note that Victor Zollo, President of the Fund's longest domestic equity investment manager, DePrince, Race & Zollo (which currently manages approximately $110 million for the Fund and has managed Fund assets since September 1994) was a speaker at the Klausner 2015 public pension client conference and the manager may have paid to sponsor the conference.

Based upon interviews with past sponsors of the conference, it is our understanding that the cost of sponsorship of the General Counsel's public pension client conference remains at $30,000.

From late June through September 2015, we repeatedly requested information from the Fund Administrator regarding any such payments by Fund fiduciaries to the General Counsel. The Fund Administrator's final response was "Unknown." When asked whether he would ask the General Counsel for such information—information the Fund Administrator stated he did not know—he did not respond to us.

It is our understanding that the City Council will subpoena from the General Counsel records of any compensation received from Fund fiduciaries.

- **Allegedly Illegal Senior Staff Pension Plan**

On July 30, 2012, the Times Union published an article stating that "since the late 1990s, Fund Executive Director John Keane has been signed up for a pension created for him by the fund with little outside notice." Both former City Council auditor Bob Johnson and current council auditor Kirk Sherman are quoted in the article as saying they were unaware of the existence of the pension program, which only covered a handful of fund employees, until that month.

According to the article, the existence of this "Senior Staff Voluntary Retirement Plan" was officially "recognized for the first time" in a recently released actuarial study of the Fund. The plan reportedly had $2.3 million in assets at that time, with the money invested along with the Fund's assets. The Plan could pay as much as $200,000 a year when Keane retired, according to the Times Union.

Shortly thereafter, the City's General Counsel issued an opinion that the Fund was not authorized under the City Charter to create the "Senior Pension Plan" and demanded the money spent to fund the pensions be repaid. The Fund's General Counsel countered that its opinion as to the legality of the plan, as originally expressed in 1999 (in connection with establishment of the plan), remained unchanged.

In 2012, the City Council voted unanimously to file a lawsuit regarding the plan but, for whatever reasons, never did. While the City General Counsel had gone so far as to tell the Fund to stop putting money into the account, a large cash infusion of more than $250,000 reportedly went into the account subsequently and effectively placed the account at over-funded status. On September 21, 2015, the Jacksonville City

Council voted 18-1 to take legal action regarding the specially created pension.

It appears that neither the City General Counsel nor the Fund General Counsel reviewed whether, in connection with the staff pension, the Board discharged its responsibilities consistent with the heightened fiduciary standards of ERISA.

We recommend that the City Council in connection with any potential litigation regarding the separate senior pension examine separately wh[illegible] [illegible]e Board, consistent with its ERISA fiduciary duties, followed a [illegible]cess in deciding to take assets from the underfunded pensi[illegible] establish, maintain and fully-fund the generous senior staff plan.

[illegible]gations of Waste, Abuse and Ethics Violations Regarding [illegible]rd and Staff Travel

Publi[illegible] on trustee and staff travel to attend lavish conferences globally, underwritten primarily by Wall Street (and, increasingly, plaintiff class action securities law firms) seeking to garner asset managem[illegible]nt and legal contingency fees from these funds has for decades [illegible]en highly controversial nationally.

So controversial are these conferences that the website for the 2013 National Conference on Public Employee Retirement Systems held on the famed beaches of Waikiki, supplied board members hoping to shore up support for their expenses-paid trip a "2013 Attendance Justification Tool Kit."

Both the Fund Administrator and General Counsel are regular participants at public pension conferences and have long defended them. The General Counsel's firm has served as general counsel for more than 15 years to the above-mentioned National Conference of

Public Employee Retirement Systems and actually puts on its own annual public pension trustee and staff conference.

There is broad consensus that the educational content of many public pension conferences is suspect. Even the Fund's General Counsel has acknowledged the abuses, as the Fund Administrator has claimed the Board monitors conference attendance for value.

According to a memorandum to the Jacksonville Ethics Commission from Carla Miller dated November 3, 2014, during 2013 and 2014, the Ethics Office investigated complaints concerning allegations of waste, abuse and ethics violations pertaining to the travel of the Fund Administrator and Bobby Deal (Chair of the Board).

Miller concluded, "There is a lack of analysis and/or oversight of the many trips taken as to their value to the PFPF Fund." The Ethics Director recommendations to the Ethics Commission included additional review of Keane and Deal travel by the Council Auditor.

In our opinion, the likelihood that public pension board members and staff who lack investment experience will learn anything meaningful regarding pension investing through travel to exotic locations is remote.

Further, the risks related to such high-stakes marketing junkets are substantial and, in our opinion, far outweigh any educational benefit. The potential for corruption of the investment decision-making process at pensions, resulting in higher fees and lower performance, is obvious and enormous.

Most recently, the Fund Administrator's travel, including 31 trips since 2010—to destinations including Scotland and Canada and staying at hotels such as Caesars Palace, Hotel Frontenac, Four Seasons, and Trump Tower—has emerged as an issue in connection with the

estimated almost $475,000 he has already and is expected to collect for unused vacation days in the past five fiscal years.

In summary, given that: (1) public pension trustee and staff travel to lavish conferences globally has generated controversy for decades across the nation; (2) the Board and Keane's travel has been intensely criticized locally (including an Ethics, Compliance and Oversight Office Review); and (3) the severely underfunded status of the pension, it is recommended that the Board and staff eliminate such non-essential travel.

Most important, extensive travel by the Board and staff is inconsistent with the fiduciary obligation under ERISA to manage plan assets for the exclusive benefit of the participants, in our opinion.

- **Board Lack of Scrutiny of Investment Management Fees- $6 Million in Excess Fees Paid Annually**

It is well established that sponsors of public and private retirement plans have a fiduciary duty to ensure that the fees plans pay money managers for investment advisory services are reasonable. Fees paid for retirement plan investment services have always been an important consideration for ERISA retirement plan fiduciaries. Further, in recent years such fees have come under increased scrutiny because of class action litigation, Department of Labor regulations, and Congressional hearings.

We requested from the Fund Administrator any analyses that may have been prepared for the Board to scrutinize whether the fees the Fund pays its asset managers are reasonable. Remarkably, according to the Fund's investment consultant, Summit Group, no fee analyses have been prepared for the Board by Summit or any third party for this $1.43 billion pension.

"The net fees paid are buried in the investment performance reports," we were told.

However, according to Summit, the Fund Administrator had instructed the firm to prepare the first such report for our review.

In our opinion, without a comprehensive fee analysis prepared by the investment consultant or a third party, the Board cannot fulfill its fiduciary duty to monitor the reasonableness of fees the Fund pays its investment managers.

We also noted the Fund has no most favored nation ("mfn") provision in any of its contracts with investment managers and does not require managers to certify quarterly or annually that the Fund is receiving the lowest fee they offer. However, the current investment consultant to the Fund agrees that mfn provisions are commonplace, particularly with respect to public pensions and helpful in reducing fees.

Even based upon the Summit analysis prepared for us (which, as explained in the report, we believe is deeply flawed) the fees paid to virtually all the U.S. Equity investment managers are 50 percent higher than they should be, in our opinion.

We recommend that all of the investment advisory fees the Fund pays its managers be fully disclosed to the Board and compared against the fees *public* pensions *actually* pay (as opposed to "published" fees), as well as, if need be, vigorously renegotiated. The emphasis on active management should be reexamined since (as noted below) long term underperformance of the active managers net of fees has been costly to the Fund.

For managers that utilize performance-based fees, the prospective fee in the Summit analysis included only the base fee and not any performance component. Further, we note that with respect to real

estate and Energy Master Limited Partnerships, we do not believe all applicable fees have been included in the Summit analysis.

In our opinion, investment costs could easily be dramatically reduced, saving the Fund perhaps **$6 million** annually or **$36 million** over the past six years, and, more importantly, improving performance. Further, we do not believe that the prospective fees for Year-End 6/30/15 amount to only 48 basis points or almost $8 million, as indicated in the Summit analysis. Rather, we estimate total investment management fees alone are **$10 million** or more annually.

- **Suspect Data Suggests $370 Million Underperformance Losses**

According to the Fund Administrator, Northern Trust (which has been the Master Custodian for the Fund for over a decade) cannot provide investment return information on a gross and net basis because the bank was not engaged to report on the Fund's performance in the past and cannot create a performance history at this time.

While the custodian can and does routinely provide performance information to pensions, the Board chose to have the former investment consultant, Merrill Lynch and now Summit, provide it. This is highly problematic because:

1. The custodian, as holder of the Fund's assets, is always in the best position to verify values and performances of the respective investment managers;
2. The consultant and the managers are subject to a conflict of interest in calculating performance; and
3. Here, as discussed extensively below, the integrity of the former consultant to the Fund—the party calculating performance over a two decade period—was challenged by regulators.

As a result, according to the Fund Administrator, the only performance reports that exist at this time for the 20-year period when Merrill Lynch was the investment consultant were prepared by Merrill—information which has not been verified by the custodian holding the assets.

Further, the current investment consultant, once retained, undertook no analysis of Merrill's performance reports. Summit was never asked by the Board to verify the Merrill performance figures. Rather, Summit simply "downloaded a giant spreadsheet in 2007 from Merrill and uploaded it into the Fund's performance history."

The Merrill gross and net annual performances reported from 1988 through 2001 were identical—no difference was indicated between the performance before and after fees. Since we know that the Fund paid investment management fees during this 13-year period, either the gross or net figures (or possibly both) must be wrong. Further, from 2002 through today, the difference between gross and net performance has inexplicably ranged from as low as 5 basis points to 55 basis points.

In conclusion, the performance of the Fund since 1988 is inaccurate, at least in part—a fact which the Board should have easily detected.

According to the current consultant, on a net basis—even based upon suspect long-term performance data provided by the former consultant—the Fund's US Equity, International Equity, and Fixed Income actively managed assets—approximately 83 percent of total assets—have underperformed their respective indices for virtually all 1, 3, 5 and 10-year periods. If the long-term performance is inflated (gross) then the actual (net) investment performance may be worse.

As discussed more fully in the report, we compared the adjusted net investment performance of the Fund that we were provided from 1988 through 2014 against a 75 percent S&P 500 and 25 percent Barclays Aggregate index and concluded that the performance of the Fund would

have improved by approximately **$370 million** had the assets been invested in low-cost, highly-liquid, fully-transparent index funds.

In other words, a significant factor contributing to the underfunding of the pension appears to have been poor investment decision-making by the Board.

We note with great emphasis that due to the Board's failure to diligently scrutinize Fund performance, the performance history is so uncertain that any analysis is inherently speculative. We understand the City Council may subpoena from the Fund's Master Custodian the relevant records since 1988, as well as verify and report to stakeholders the true net performance.

- **$27 Million Loss Gambling on Energy Master Limited Partnerships**

Three years ago, the Fund invested approximately $106 million or 6.75 percent of its assets with two investment managers who are paid to invest fund assets exclusively in Energy Master Limited Partnerships (MLPs). In addition to lacking diversification, these investments are subject to regulatory, interest rate, and liability risk. MLPs involve significant fees at the partnership level (2 percent or more)—in addition to the fees (75 basis points) the Fund pays the investment managers.

In the past year, the Fund's MLP investments have lost 33 percent in value and over a three-year period, they have significantly underperformed (3.5 vs. 12.5 percent) the public equity market.

Note that 9 percent underperformance over 3 years amounts to **$27 million** in underperformance losses without compounding.

According to the Wall Street Journal, as the price of oil has fallen, these investments have continued to plummet in value. The Alerian MLP

index fell 15.3 percent last month—the third-worst monthly loss in its nearly 20-year history. The average MLP mutual fund, according to Morningstar, lost 15.8 percent for the month.

In our opinion, gambling on opaque, high-cost, high-risk MLP investments is imprudent, especially for a severely underfunded pension—regardless of the multi-million loss outcome.

- **Need to Account for $5.7 Million in Commission Rebates**

"Commission recapture" is a process whereby a pension plan receives a rebate in connection with brokerage transactions incurred through the pension's investment managers. This rebate represents a portion of commission (equity trade) or spread (fixed income trade) charged on these investment transactions.

Commission recapture arrangements are indirect payment schemes that may compromise transparency and accountability, as well as present conflicts of interest for all fiduciaries involved.

Boards or staff who use recaptured funds for purposes other than the best interest of the plan and beneficiaries may violate their fiduciary duties and applicable law.

Even the largest public pension in Florida was scarred by a commission rebate scheme in 1999, when a member of the staff of the Florida State Board of Administration was discovered to have embezzled more than $400,000 in brokerage rebates.

According to a 1994 article, the Fund started its commission recapture program in 1987, when the Board instructed its money managers to place all buy and sell orders through a New York-based brokerage firm. From 1987 to 1994, the Fund Administrator publicly claimed that the Fund had saved more than $600,000 in commission costs. He also

indicated that commission recapture funds had been used to purchase the Fund's office building.

The article goes on to quote the Fund Administrator saying that the Fund's policy is" ABC-all brokerage recaptured."

We requested annual statements of commissions recaptured by the pension since 1987, as well as documents related to the expenditure of the recaptured amounts.

Instead we were provided with statements indicating commissions recaptured since 2005 (not since 1987, as requested) in the amount of $1.936 million. Assuming the Fund has recaptured approximately $200,000 per year since 1987, approximately **$5.7 million** in commissions may have been rebated.

In response to our question regarding how the commission rebates had been spent, we were simply told, "The funds were deposited into our General Account."

As noted above, the Fund Administrator himself has mentioned in speeches that recaptured commissions were used to buy a building for the Fund's offices.

In our opinion, stakeholders should be provided with a full accounting of all rebated dollars in order to determine whether they have—consistent with heightened ERISA fiduciary standards—been used for the exclusive benefit of the participants. In the event any such funds have been misused, the funds should be recovered.

Note that actively managed accounts with higher portfolio turnover generate greater commission rebates. The Board's emphasis on recapturing commissions may have led to excessive reliance upon active management, contributing to the Fund's overall underperformance.

We understand that the City Council may subpoena records related to the receipt and use of rebated commission dollars since 1987.

- **High Cost of Decades of Conflicted Gatekeeper Advice**

The Board utilizes the services of an investment consultant who advises the Board on investment policies and decisions, and who assists in implementing those decisions. The Board does not utilize an investment committee consisting of knowledgeable investment and financial professionals that could be helpful to assuring sound financial and investment decisions by the Board.

In early 1996, questions surrounding conflicts of interest related to pension consultants began to attract national attention.

By 2000, the dangers related to Florida-based pension consultants with affiliated securities brokerages were being discussed with local public pensions and their attorneys.

In 2002, Edward Siedle, President of Benchmark, was invited to give a speech specifically focused upon pension consultant conflicts at the annual Florida Police and Firefighters Pension Trustee Educational Seminar. The breach of fiduciary duty that results when an advisor, retained to provide objective advice to pensions regarding allocation of assets and selection of money managers to invest such assets, receives brokerage compensation from the very money managers he recommends to his pension clients was explained. Details regarding the first-ever investigation of broker-consultant conflicts for a public pension in Nashville that resulted in a $10 million recovery for the single public pension was provided. Attendees were warned of the potential damages to Florida police and firefighter pension plans.

Around this time, Siedle met with and discussed conflicts of interest involving Merrill Lynch—the Fund's then investment consultant—

specifically with the Fund Administrator, Fund General Counsel and attorneys from BLBG accompanying the Fund Administrator. In light of the potential harm to the Fund and other Florida public pensions, Siedle urged them to take immediate action.

In late 2003, the staff of the SEC announced an inquiry into conflicts of interest involving investment consultants to pensions. Benchmark worked closely with the SEC on this inquiry. Securities regulators from the State of Florida came to our offices to review files regarding the consultant abuses we had uncovered.

On May 16, 2005 the staff of the SEC's Office of Compliance Inspections and Examinations issued a report which, in part, concluded that conflicts of interest were pervasive and disclosure practices lacking in the investment consulting industry.

Weeks later, the SEC and Department of Labor issued a publication entitled "Guidance Addressing Potential Conflicts of Interest Involving Pension Consultants."

Most significantly, conflicts of interest at investment consulting firms were found to result in substantial financial harm to plans by the U.S. Government Accountability Office ("GAO") in a 2007 report, i.e., plans using consultants with undisclosed conflicts of interest had annual returns generally **1.3 percent lower.**

For almost twenty years, from 1988 through December 31, 2007, Merrill Lynch, a broker-affiliated investment consultant, served as the investment consultant to the Board. If, as the GAO study found, pension consultant conflicts cost plans 1.3 percent, then over a 20-year period, with compounding, such conflicts may have cost the Fund **almost 30 percent** of its value—perhaps **$300-$500 million**.

Apparently throughout the consulting relationship Merrill Lynch's trading desk received trading commissions from investment managers that Merrill Lynch Consulting Services recommended to the Fund, in addition to a "hard dollar" annual fee from the Fund.

The General Counsel of the Fund publicly stated that the trades by the Fund's managers with Merrill's brokerage arm were "separate, so conflicts are less inherent" and "even if trades are made through Merrill Lynch's brokerage arm, those fees never make their way back to the consulting arm."

In 2003, when, according to The New York Times, Merrill Lynch paid to sponsor the General Counsel's annual client conference, Board members and Fund General Counsel were, according to documents we were provided in connection with this review, questioning Merrill regarding conflicts and business practices.

In December 2004, The New York Times wrote an article, How Consultants Can Retire on Your Pension, which discussed that potential consultant conflicts were greatest at firms with brokerage or trading operations. It was also stated that Merrill Lynch Consulting Services in Jacksonville had almost 100 pension funds in Florida as its clients but that some Florida funds had already fired the firm and replaced it with an independent consultant.

In December 2005, The New York Times ran an article entitled, "Merrill Unit Subpoenaed on Pensions." It was now widely known that the SEC was investigating Merrill's pension consulting operation in Florida.

In early 2006, the SEC contacted the Fund requesting voluntary cooperation in an investigation of Merrill. The Wall Street Journal reported on March 12, 2007 that Merrill had begun issuing refunds to public pension clients in Florida. On Sunday, November 4, 2007, the New

York Times ran an article regarding the SEC investigation of Merrill and the letters the firm had sent to clients.

By late 2007, when an SEC enforcement action against Merrill appeared imminent, Fund General Counsel recommended terminating the agreement with Merrill effective December 31, 2007, as well as tasking the new consultant with an in depth review of Merrill's reports and practices to determine if any previously undisclosed concerns were present and authorizing discussion with the Fund's securities counsel to determine if the Fund had suffered a recoverable loss.

On May 2008, Merrill announced it was closing down its Florida pension advisory practice and in January, 2009, the SEC took action against Merrill. Merrill Lynch agreed to settle the SEC's charges and pay a $1 million penalty.

On July 15, 2010, 76 Florida local public pensions, including the Fund, filed a detailed putative class action complaint against Merrill Lynch.

On March 23, 2012, the parties entered into a settlement resolving the matter for $8.5 million. Attorneys for the plaintiffs, including BLBG and the General Counsel's firm, shared $2.125 million in legal fees.

In response to our request for information, we were provided with a check dated February 28, 2013 made out to the Fund in the amount of $273,696.64 and a letter indicating that the check represented the Fund's pro rata share of the net settlement fund from the class action case brought against Merrill Lynch. It appears that, aside from an earlier transaction management credit of $10,000, this is the total compensation the Fund received from Merrill Lynch.

Since, based upon the GAO study, pension consultant conflicts may have cost the Fund almost 30 percent we requested any evaluation or review of the damage caused to the Fund by Merrill over the decades.

The Fund Administrator provided no such analysis and, as indicated above, the new consultant indicated it undertook no such review.

In our opinion, the Board failed to heed credible warnings and adequately investigate conflicts of interest related to the Fund's consultant for years. Based upon the documents we were provided, it appears the Board did not question the receipt of compensation by the General Counsel's firm—an obvious potential conflict of interest noted in The New York Times—from the consultant during the period. Even after terminating Merrill, the Board failed to conduct or commission any review of the potential harm to the Fund caused by Merrill, choosing instead to accept a settlement of a mere $273,696, for an estimated (based upon GAO analysis) $300-$500 million in underperformance losses. The Board failed to investigate the fact that the gross and net investment performance of the Fund as reported by Merrill were inexplicably the same for many years.

- **Current Consultant- Summit Strategies Group**

At least since the termination of Merrill Lynch, the investment consultant to the Board has been Summit Strategies Group.

While the list of the consultant's duties in the contract between the consultant and the Fund and the Statement of Investment Policy is extensive, conspicuously absent is any specific obligation to advise and assist the Board in negotiating and evaluating the investment advisory fees the Fund pays.

The Board's contract with Summit provides that information needed to provide the investment evaluations required of the Fund and its investment managers are generally contained in the records and reports of the custodian bank and that the consultant is entitled to reasonably rely upon such information.

While the custodian bank could provide such performance information, the Board under Merrill Lynch and now under Summit, continues to rely upon the consultant for performance analyses.

We recommend the contract between the Fund and its Master Custodian be amended to include calculating investment performance and that the Fund rely upon any investment consultant for only advice and analysis of such verified investment performance. We also recommend that the contract between the Fund and any investment consultant be amended to include a duty to advise the Board on the reasonableness of the investment advisory fees the Fund pays.

- **Plaintiff Class Action Monitoring Agreements**

The Fund has entered into agreements with multiple securities class action law firms to monitor its investment portfolio in order to determine whether the Fund has suffered any loss due to violations of federal and/or state securities laws, calculate losses, identify breaches of fiduciary duty and other corporate misconduct.

Some have severely criticized these "portfolio monitoring" arrangements between pensions and class action firms. One highly regarded federal judge, Judge Rakoff, noted in 2009, that such an arrangement was "about as obvious an instance of conflict of interest as I've ever encountered in my life." He said he was shocked that persons with a fiduciary duty to monitor pension investments would choose "to save a few bucks" by hiring a law firm to monitor those investments that could only profit by recommending litigation.

In response to plaintiffs' counsel's suggestion that his law firm analyzed and evaluated the merits of the case before recommending that the fund become involved in litigation, Judge Rakoff said that arrangement "makes crystal clear that the Iron Workers (the pension involved) *are*

being led by counsel rather than the other way around (emphasis added)."

We were provided with and reviewed portfolio monitoring agreements between the Fund and Bernstein Liebhard; Cohen Milstein; Berman DeValerio; and Spector Roseman. Again, we note that no portfolio monitoring or any other agreement between the Fund and the law firm of BLBG has been provided to us, despite our repeated requests.

The relationship between BLBG, the Fund and the Fund Administrator has been longstanding and is widely known.

The agreements Bernstein Liebhard and Berman DeValerio are relatively new (2011 and 2012, respectively) and seem quite broad, indicating that these firms will proactively identify instances of abuse by corporate management and breaches of fiduciary duties under federal securities, state securities, corporate and related areas of law. Whether class action securities firms, in general, are truly capable of ferreting out all such abuses is uncertain.

For example, based upon information provided by the Fund Administrator, it appears that no law firm monitoring the Fund's investments over the period from 1988 through 2008 notified the Fund of fiduciary breaches related to Merrill Lynch Consulting Services early on—breaches for which the SEC later took action against the firm.

Whether any firm monitoring the Fund's investments during this period represented that it would notify the Fund of any such fiduciary breaches should, in our opinion, be reviewed—if for no other reason than to determine whether the Fund should continue to rely upon any such firm to identify key fiduciary breaches related to its investments in the future.

- **Placement Agent Contingent Fees**

Placement agents are intermediaries or middlemen paid by external investment managers to market and sell their investment products. Placement agent fees are paid directly by money managers and indirectly by investors through higher asset-based fees than would be available absent the compensation arrangement between the manager and the intermediary.

The investment advisory contracts between the Board and the Fund's investment managers we were provided in response to our request generally include a provision stating that the manager warrants that it has not employed or retained a placement agent.

In response to our specific question the Fund Administrator represented that that no placement agent has ever directly or indirectly received compensation related to the Fund.

We note however, the following:

1. We were only provided with the most recent contracts to review. Whether older contracts contained such provisions is unknown.
2. Certain of the Fund's investments were made pursuant to subscription agreements and, as a result, there apparently were no representations regarding placement agents with respect to these investments.
3. Illiquid investments, such as those mentioned in item 2 above, commonly involve the use of placement agents.
4. Since placement agent fees are paid by the investment manager, the Fund Administrator may not be aware of any fee that may have been paid.
5. Whether compliance with the placement agent prohibition has been monitored or enforced over the years is unclear.

- **Conclusion**

As summarized above and detailed in our report, in our opinion, the Board has failed to provide oversight, consistent with its fiduciary duties, with respect to matters as fundamental as recording, evaluating and reporting investment performance of the Fund over time; investment manager and other vendor compliance with state and federal heightened ERISA fiduciary standards adopted by the Fund; monitoring conflicts of interest and establishing corresponding safeguards; and reviewing, as well as assessing, the reasonableness of investment management and other fees paid by the Fund.

While the Board, staff and others related to the Fund will, no doubt, dispute some or all of these findings, we believe that providing all the relevant information related to the issues identified in this report to the public, regulators and law enforcement, can only benefit all stakeholders in the Fund, as well as the nation.

END EXECUTIVE SUMMARY