REVIEW OF INVESTMENT CONTRACT FOR WORKERS' COMPENSATION ASSIGNED RISK PLAN

April 1990

Office of the Legislative Auditor
State of Minnesota

Veterans Service Building, Saint Paul, Minnesota 55155 • 612/296-4708

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
VETERANS SERVICE BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

April 19, 1990

Senator John Brandl, Chairman
Legislative Audit Commission

Dear Senator Brandl:

I am transmitting to you our report on the procedures used by former Commerce Commissioner Mike Hatch in awarding a contract to Dougherty Dawkins Portfolio Advisory Service to manage investments for the Workers' Compensation Assigned Risk Plan. The Legislative Audit Commission requested the review on February 9, 1990.

We do not think any laws were violated, nor did we find evidence that the process was politically motivated. However, we conclude that the contracting process was poorly managed: the solicitation of bids was too limited and informal; the evaluation of proposals was inadequate; and the final decision was based too much on personal impressions rather than a clear understanding of the law and the application of good management practices. Mr. Hatch maintains that because he regulated the financial services industry, a more formal and extensive contracting process was not necessary.

Our review was conducted by Margaret Jenniges and Lawrence Goga from the Financial Audit Division and Tom Walstrom from the Program Evaluation Division. We received full cooperation from Mr. Hatch, the Department of Commerce, and everyone else we contacted for information.

Sincerely yours,

James R. Nobles
Legislative Auditor

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INTRODUCTION

On February 9, 1990 the Legislative Audit Commission directed the Legislative Auditor to review allegations made against former Commerce Commissioner Mike Hatch. The allegations concerned his actions in awarding a contract to Dougherty Dawkins Portfolio Advisory Service to manage investments for the Workers' Compensation Assigned Risk Plan. The allegations were made by State Auditor Arne Carlson first in a letter to Governor Perpich on December 18, 1989 and then to legislative leaders in a letter dated January 5, 1990.

On January 17, 1990 a bipartisan group of eight legislative leaders asked the Legislative Audit Commission to direct the Legislative Auditor to investigate the allegations made by Mr. Carlson. A copy of their letter and Mr. Carlson's is in Appendix A.

In summary Mr. Carlson made the following allegations:

1. **The contracting process was politically motivated and directed to benefit the eventual recipient of the contract.**

2. **The contract recipient submitted an incomplete bid.**

3. **The stated reason for not renewing the contract with IDS, the previous manager, had little basis in fact.**

4. **The fee arrangment of the contract recipient was improper.**

To ensure that our review was thorough we added to Mr. Carlson's questions these broader questions:

1. **Were any laws violated?**

2. **Were good management practices followed?**

The fact that the original allegations were made by one candidate for governor (Mr. Carlson) against another candidate for governor (Mr. Hatch), undoubtedly gave them some political coloration. However, the allegations were brought to the Legislative Audit Commission by a bi-partisan group of Senate leaders, and the Legislative Audit Commission, which is composed of House and Senate members from both parties, took its action on February 9 by a unanimous vote.

In conducting the review we followed our standard procedures. This report, as all others issued by our office, is solely the product and responsibility of the Legislative Auditor and his staff.

METHODOLOGY

Our methods were straightforward: we reviewed documents at the Department of Commerce related to the investment contract and we interviewed the people who participated in the contract award process. A list of the people we interviewed is included as Appendix B.

BACKGROUND

By statute, Minnesota employers must purchase workers' compensation insurance in order to conduct business. Availability of insurance is assured by a Workers' Compensation Assigned Risk Plan administered by the Minnesota Department of Commerce. Employers whose application for workers' compensation insurance is denied by an insurance company can receive coverage from the plan. The Minnesota Department of Commerce contracts with several servicing organizations to collect workers' compensation premiums and to pay losses. The money left after paying current expenses is invested to pay for future workers' compensation claims.

Prior to 1982 the insurance industry managed the Workers' Compensation Assigned Risk Plan. In mid-1982, the Department of Commerce assumed management of the plan from the industry.

The Legislature established an Assigned Risk Plan Review Board to oversee the plan. The board has two primary functions: to audit the loss reserves of plan service contractors; and to monitor operations of the plan and submit recommendations for improvements. The Commissioner of Commerce is one of six board members. In addition to being a board member, the commissioner is also responsible for administering the plan. He has the authority to enter into service contracts as necessary to accomplish the purposes of the plan. The commissioner also may assess licensed insurers if the plan's premiums are insufficient to fund its obligations. A department employee is assigned as a plan coordinator. The coordinator is a liaison with the servicing contractors, actuary, investment manager, and custodian.

The board met periodically from March 1982 through November 1983, according to board minutes we located. They selected the contractor for the audit of the reserve and reviewed claims. A department representative attended the meetings to inform the board of any plan developments, assessments and plan rate increases. A former board member told us that because the board was ineffective they stopped meeting.

The 1984 Request for Investment Management Services

By April of 1984, the excess of premiums collected over claims paid out had grown to $17.3 million, which was invested by Norwest Bank Midland. In April 1984 the Department of Commerce issued a request for proposals for investment management and trustee and custodial services for the Assigned Risk Plan portfolio. Because the fund was expected to grow to between $50 and $75 million, department staff felt a professional money manager should handle the investments. Department staff asked for, and received, the help of the Public Employees Retirement Association in putting together their request for proposal (RFP). The RFP was advertised in the *State Register* on April 16, 1984 for a contract to begin June 1, 1984. The bids were due at the Department of Commerce by May 11, 1984. The Assigned Risk Plan Review Board played no part in the selection of the investment advisor.

The Department of Commerce received eleven proposals from local investment firms to manage the $17 million portfolio.[1] The department evaluated each of the proposals based on how well they had responded to the items specified in the RFP. Commerce staff then narrowed the list to four firms and invited them in for interviews. We could find no record of a formal analysis of the firms' investment performance.

A contract for investment management services was awarded to IDS Advisory Group effective June 29, 1984 through December 31, 1986; and a contract for custodial services was awarded to First Trust of St. Paul.[2]

At the time the 1984 request for proposals were solicited, the Department of Commerce had not decided on an appropriate investment policy for the portfolio. According to many investment managers we talked to, it is normal that the investor specify the investment parameters of the portfolio. Part of the requirements of the department's request for proposal was for the respondents to submit suggestions for the portfolio's asset allocation. Based on its market forecast and the investment objectives of the Assigned Risk Plan, IDS proposed an initial asset allocation of 75 percent investment grade fixed income securities, 20 percent equities, and 5 percent cash or cash equivalents.[3] Commissioner Hatch told us that his intent was to have allowable investments

1 We do not know what process was used in 1984 to solicit bidders. Department staff do not remember and the documents regarding the RFP are not clear.

2 Although the IDS contract award letter was dated June 29, 1984, the contract was not signed by all parties until August 1984. IDS did not begin managing the portfolio until the middle of July 1984.

3 Investment grade securities are normally considered those with credit ratings of Bbb or better.

similar to those of banks. However, the investment policy for the portfolio that was incorporated into the contract with IDS on September 19, 1984 was much more conservative than that recommended by IDS or than that allowed commercial banks. The investment policy that was adopted called for a maximum maturity of fixed income securities that could not exceed 3 years and fixed income investments consisting of government securities and Aaa-rated corporate bonds. Cash equivalent securities also had to have the highest ratings. The asset allocation of the portfolio was 80 percent fixed income securities, 15 percent equities, and 5 percent cash or equivalents. It is unclear exactly why the contract did not follow what the commissioner recalls as his intended investment policy. The former plan coordinator told us that it was anticipated that the fund would grow and then be drawn down to pay claims, so a three year limit was put on maturities.

Both from a maturity and a credit risk standpoint the portfolio was very conservative. Since there is a direct relationship between risk and investment return, and normally between fixed income securities' maturity dates and return, the portfolio could expect a lower return as a result of the restrictions placed on its investment manager.

The Department of Commerce and IDS agreed on performance measures of the Standard and Poors 500 Stock index for the equity portion of the portfolio and the Salomon Brothers government medium term (1-3 year) bond index for the fixed income portion. IDS reported their performance against these indexes monthly to the Department of Commerce. In addition, the custodian, First Trust of St. Paul, independently reported the portfolio's holdings and transactions monthly to the department.

In September of 1986, three months before the contract was to expire, the Department of Commerce and IDS mutually agreed to extend the terms of the contract for one year. In August of 1987, the Department of Commerce Assigned Risk Plan Coordinator recommended to Commissioner Hatch that the contracts with IDS and First Trust be extended for another one-year period, until December 31, 1988. The reasons for renewing the contract were stated as follows:

1. **The performance of IDS and First Trust in providing services to the Plan had been excellent.**

2. **The investment income on the IDS managed portfolio had been excellent-ranging from 5-1/2 to 10%.**

3. **Both companies had been extremely helpful in providing information and answers to the Department of Commerce's questions.**

As a result, the contracts were extended to December 31, 1988.

The Decision to Open the Contract for Bids

On March 1, 1988, approximately six months after the contracts had been extended for 1988, the plan coordinator wrote a memo to Commissioner Hatch recommending that the contract be opened for bid unless IDS was willing to renegotiate and to lower its service fee. The reason stated was that the plan had grown considerably larger than expected. When the original contract with IDS was awarded, the department anticipated an investment portfolio of approximately $50-$75 million. The service fee bids were based on the projected size of the account. However, by March of 1988 the account had grown to approximately $150 million. The plan coordinator wanted to renegotiate the fees that IDS charged, but Commissioner Hatch felt that contracts of this nature should be periodically opened for bid.

Accordingly, in September 1988, a request for proposal for investment management services for the Workers' Compensation Assigned Risk Plan was issued. Bids were to be returned by November 1, 1988. Although the plan is exempt from following normal state agency contract procedures, Department of Commerce officials decided to publish a notice of the request for proposals in the *State Register*. According to officials in the department they were following normal state procurement procedures. They told us that they were not aware that they could advertise elsewhere for services. Only two proposals (from IDS Advisory Group and First Asset Management) were submitted in response to the request for proposals.

Commissioner Hatch rejected both bids because he felt that two bids were not enough to establish a competitive price for the investment management services. The commissioner told us he, "junked the bids because we were getting above market rates." The plan coordinator said it was because two bids were not enough to establish a competitive price. According to Mr. Hatch, he instructed the plan coordinator to rebid the project and to make some phone calls to identify additional bidders. According to IDS and First Asset Management, they were told that the contract was rebid because there were only two bidders.

The Department of Commerce coordinator for the plan changed in late November 1988. The former plan coordinator said the decision to reject the bids had not been made when she changed positions, and that she was not asked to rebid the project or to solicit more bidders. The new coordinator prepared a second request for proposals but did not try to solicit additional bidders for the contract.

The notice for the second RFP was published in the *State Register* on February 13, 1989. Responses were due by April 13, 1989 and the contract was to run from May 1, 1989 until May 31, 1991.[4]

According to Mr. Hatch, he had conversations with four individuals regarding the investment management contract; three of them were lobbyists represent-

4 The notice in the *State Register* erroneously stated that the contract was to run from May 1, 1989 to May 31, 1989. The contract term was correctly stated in the request for proposals.

ing various financial firms. We contacted these individuals. Two of the three lobbyists represent investment firms at the Legislature, and the third formerly did so. One of the lobbyists said that he does not remember Commissioner Hatch contacting him about this matter. The second told us he might have had a conversation with Commissioner Hatch about the "Assigned Risk Pool", although he does not remember a conversation about an investment management opportunity. The third said he does not remember any contact, and if there was he would probably have told Commissioner Hatch that he no longer represented any financial firms. In any event, we contacted the financial firms the lobbyists represented, and they did not know about the proposed contract, although they would have been interested in submitting a proposal.

The other person that the commissioner talked to was Michael Pint, the president of Central Financial Services. Central Financial Services (CFS) is a bank service corporation providing tax, management, and investment services for 23 banks in the Upper Midwest. According to Mr. Pint, Commissioner Hatch called him in the first quarter of 1989 and, during the conversation, he mentioned that the department was seeking proposals to manage a $200 million portfolio of the Assigned Risk Plan. Commissioner Hatch inquired if this was something that Mr. Pint would be interested in managing or if he knew of anyone who would be. Commissioner Hatch told Mr. Pint that he was also contacting others to solicit bids. According to Mr. Pint, Commissioner Hatch said that the contract had been bid once, but that they (Commerce) weren't happy with the bids, so they wanted to rebid the contract and get more people involved. Mr. Pint said that Commissioner Hatch told him that the reason it was being bid, and then rebid, was because he thought that IDS should renegotiate its price and that they did not want to do that. Mr. Pint said that he had the impression that the commissioner wanted to know if the department was getting a fair price.

Mr. Pint said that since his company was not an investment advisor registered with the SEC, it could not manage the portfolio itself. However, CFS was interested in the contract since they do manage a fixed income portfolio of about $300 million for their own banks. Mr. Pint called Dougherty Dawkins to see if they might be interested in submitting a joint proposal. Dougherty Dawkins is a registered securities broker dealer and investment banking firm with which CFS does business. Dougherty Dawkins had recently formed a subsidiary, Dougherty Dawkins -- Portfolio Advisory Service (PAS), to perform investment management services. According to Dougherty Dawkins officials, Mr. Pint contacted them during the early part of April 1989.[5] Mr. Pint told Dougherty Dawkins that the contract was for a $200 million portfolio that they were interested in bidding on, but he did not disclose the potential client's name at that time. Dougherty Dawkins PAS was interested in pursuing the potential contract because they were a newly formed firm with no other investment management contracts. PAS and CFS agreed to split the fee. For their share CFS was to provide economic consulting services. Mr. Pint disclosed who the proposal would be submitted to when Dougherty

5 Portfolio Advisory Service (PAS) application to become a registered investment advisor was approved by the SEC on March 26, 1989. PAS submitted its application to the SEC on December 27, 1988. In October 1989, PAS was dissolved and Voyageur Asset Management, another Dougherty Dawkins subsidiary, was assigned the contract. The same employees managed the portfolio under both PAS and Voyageur.

Dawkins agreed to participate. PAS put together the proposal over the weekend of April 8-9 and the following Monday. The proposal was then submitted to the Department of Commerce on April 13, 1989.

The Contract Award Decision

Three proposals were submitted in response to the second RFP. IDS and First Asset Mangement resubmitted essentially the same proposals and a third proposal was submitted by Dougherty Dawkins Portfolio Advisory Services and Central Financial Services. Commissioner Hatch asked Department of Commerce personnel to review the proposals. The department personnel that reviewed the bids had no educational background or experience in the fields of banking, finance, or investments. On April 27, 1989, the plan supervisor wrote a memorandum to the commissioner recommending the contract be awarded to the Dougherty Dawkins Portfolio Advisory Service/Central Financial Services group. This recommendation was based solely on a review of the proposals. No one from the Department of Commerce contacted any of the references, or contacted the firms submitting proposals with questions, or formally interviewed the respondents.

According to Mr. Hatch, he based his decision on several factors. He reviewed the memo from the plan coordinator that recommended Dougherty Dawkins. Also, the Department of Commerce's contracting official told him that he had to accept the bids if they were "within market", unless he could give a reason for not doing so. Mr. Hatch had read in a trade journal that he should be paying a fee of between 11 and 15 basis points on a portfolio like the Assigned Risk Plan's.[6] Dougherty Dawkins fee was 13 basis points, or "within market", and since Mr. Hatch felt they were a competent firm, he felt he had to award the contract rather than rebid the contract for a third time.[7]

We asked Mr. Hatch how he determined the competence of the firms involved. He responded: "All these firms were competent, if they weren't competent, I should have pulled their license because I regulate these guys." He said several times that Dougherty Dawkins was a well known bond firm, and that several prominent local businessmen and families had invested money in Dougherty Dawkins, and that they knew what they were doing. He told us that his financial examinations department examined and audited all of them so he knew they were competent. We asked if he had checked with the financial examiners and he said, "No, I didn't have to.... It's like going in and saying you have to kick the tires on a Cadillac. All of these companies--they are top grade."

In short, Commissioner Hatch felt that he had to award the contract to the lowest bidder, since they were all competent firms.

6 A basis point is one-hundreth of one percent, or .0001 of the whole. On a $200 million portfolio, a 13 basis point fee would be $260,000 annually.

7 IDS proposed a fee of $357,500 for a $200 million portfolio, and First Asset Management's proposed fee was $360,000. Although as we note later, the fee is not the most important factor in analyzing the bids. A better criterion is the investment return net of all fees.

EVALUATION QUESTIONS

As we stated earlier, we examined the questions raised by Mr. Carlson and we raised two broader questions of our own. For the purposes of our report we will address questions in the following order:

1. **Were any laws violated?**

2. **Were good management practices followed?**

3. **Why was the contract with IDS not renewed?**

4. **Did the bids contain adequate personnel information?**

5. **Was the process politically motivated or directed to benefit the contract recipient?**

6. **Was the fee arrangement of the award recipient appropriate?**

In addition, we reviewed a concern that several people raised about the investment policy of the plan.

1. Were Any Laws Violated?

We found no evidence that any laws or rules were violated in the award of the investment management contract. By statute, the Workers' Compensation Assigned Risk Plan and the Assigned Risk Plan Review Board are not state agencies. As a result, they are not subject to normal state controls: the Department of Finance regarding accounting; the Department of Administration regarding contracts; the Department of Employee Relations concerning hiring practices; or the State Board of Investment concerning investment of the plan's assets.

Although not required to do so, Commissioner Hatch attempted to follow state contracting procedures for soliciting bids and accepting or rejecting contracts. However, he misinterpreted state statutes and used a more restrictive process than necessary. First, the notice of the RFP was published only in the *State Register*, although other methods of giving notice could have been used. A request for proposal may also be advertised in newspapers or trade journals depending upon the nature of the contract. To solicit a sufficient number of bidders, especially after receiving only two responses to the first RFP, the department should have published the RFP notice in a trade journal, or made other efforts, such as systematically notifying local investment firms by phone or letter.

Second, state statutes allow any and all bids to be rejected after they are received and reviewed. The commissioner did this with the first bids received.

He also could have rejected the second bids and reevaluated the method used for obtaining proposals.

Generally, all state contracts are awarded to the lowest responsible bidder, taking into consideration conformity with the specifications, purpose for which the contract is intended, the status and capability of the vendor, and other considerations imposed in the call for bids. However, state law does not require that the lowest bid be accepted, and for some services--like investment services--other considerations may be more important. As discussed in the next section, investment return is a more important consideration than the fee charged.

The Assigned Risk Plan Review Board has the responsibility to monitor the operations and administration of the plan. This responsibility could include a review or discussion of a major contract before it is signed. In June 1987, the previously inactive board was re-established with new members. However, board members were not aware of the decision to solicit new bids for the plan's investment manager. The board was informed at its November 1989 meeting that a new manager had been selected.

2. Were Good Management Practices Followed?

We conclude that good management practices were not followed by the Department of Commerce in soliciting and evaluating the bids for the Workers' Compensation Assigned Risk Plan portfolio. The process was flawed in several respects. First, the method of soliciting bidders did not assure that the availability of the contract was widely known in the investment community. Second, the proposals were not adequately evaluated. Third, we believe that the commissioner's approach to evaluating the bids solely on the fee and his personal knowledge of the participants was too limited and informal.

The process used to solicit bids almost assured that there would be few bidders. Publication of the notice of a RFP in the *State Register* is unlikely to be sufficient advertisement for this type of service contract, as the department found out from its experience with the first RFP in 1988. Investment managers do not generally read the *State Register*.[8] Indeed, none of the three respondents found out about the contract from reading the *State Register*. The Department of Commerce did not actively seek additional bidders. Although Commissioner Hatch says that he mentioned the contract to several lobbyists, the department made no systematic effort to involve more firms in the bidding. In fact, many local investment firms told us they would have been very interested in making a proposal to the department had they known of the RFP.

We called six of the largest investment managers in the Twin Cities to see if they had known of the proposed contract. None of the firms' officials we contacted had known of the contract at that time. All of the firms we contacted

8 Several of the investment managers we contacted said that because of this contract they now monitor the *State Register*.

said that they would have been interested in submitting a proposal to manage a portfolio of this type.

We also contacted the State Board of Investment (SBI), by far the largest investor of public funds in Minnesota, to determine how they approach awarding investment management contracts. Through SBI's knowledge of the industry, the use of a consultant, and an investment advisory council SBI generates a list of between 25 and 60 firms to consider for the prospective contract. SBI narrows this down to 10 or 12 firms using its consultant's performance screens and other performance indicators. They also form a committee of staff, the investment advisory council, and designees of board members that does formal write-ups of the firms under consideration and then reviews them to narrow the list to four to six firms. The committee then conducts formal interviews with each firm, with the staff generally visiting the firms' place of business. They then recommend one, two, or three firms to the State Board of Investment. According to SBI staff, the fee is not a major consideration, since the investment return is much more important. SBI measures the investment return net of all fees and looks for investment managers that will add value over the return earned by the market as a whole. While the department was not required to follow SBI's procedures, good management would suggest using similar procedures.

SBI staff told us that there would likely be a great deal of interest in managing a portfolio of the composition and size of the Assigned Risk Plan. In their opinion, there would be a dozen or so local firms interested, and if the search were expanded beyond Minnesota, they believed that the department could have generated as many bids as they wanted.

The department's evaluation of the bidders was also flawed. As we indicated earlier, the department staff assigned to evaluate the bids were not qualified by education or experience in finance and investment matters. As a result, their analysis of the proposed bidders prior investment performance was faulty. The department staff unknowingly directly compared the investment returns from portfolios that varied widely from an asset allocation, maturity, and credit risk standpoint.[9] Although the results of such a simple comparision are essentially meaningless, the Department of Commerce used this comparision to project how adopting a different manager could effect potential future returns to the portfolio. Further, good management would dictate, at a mini-

9 PAS submitted its tax adjusted investment returns from a $150 million mutual fund that Dougherty Dawkins Voyageur Asset Management managed, known then as the Double Exempt Flex Fund, comprised of Minnesota tax-free governmental bonds. Bonds held in the fund have a weighted average maturity of between 15 and 25 years and 90 percent of the bonds must be rated as investment grade (Bbb or equivalent or better). Due to the nature of the Assigned Risk Plan portfolio's investment restrictions, the duration of the IDS managed Assigned Risk Plan portfolio was approximately 1.5 years, and the credit quality of the bonds was restricted to U.S. government securities and Aaa corporate bonds. However, IDS also submitted the results from balanced accounts managed for other clients. Likewise, First Asset Management supplied investment returns for its balanced portfolios, which tended to have a higher component of equities and fixed income securities with a longer maturity than the assigned risk plan portfolio.

mum, such steps as calling references and interviewing the respondents. These steps were never taken by the Department of Commerce staff.

Assessing the validity of investment managers' reported performance numbers requires careful scrutiny, and is a major concern in the investment community.[10] In our opinion, none of the proposals answered all of the questions about past investment performance that a prudent manager should ask before entering into a contract.[11] In particular, since Portfolio Advisory Service was a new entity, special scrutiny should have been given to its stated investment returns. As the Dougherty Dawkins PAS proposal properly notes: "blending the performance records of several entities may skew a meaningful portfolio management record..." In the case of each bidder, the Department of Commerce should have sought additional and comparable information regarding their stated investment performance.

Finally, we believe that Commissioner Hatch's process for deciding on the contract was too limited and informal. We are unpersuaded by his contention that one need not ask questions about the respective firms relative performance, "because they're all qualified." The issue is not a firm's general qualifications to do business in the state, rather the performance and past experience of the people being proposed to work on a project of a particular type. In making a decision about a complex professional service contract--like a contract for investment services--it is essential, in our view, that detailed information be obtained about the firms being considered and the individuals being proposed to do the work.

We are equally unpersuaded by Mr. Hatch's argument that he had to award the contract to the low bidder. As we noted in a previous section, state law does not require that. In fact, as the State Board of Investment staff noted, investment performance is by far the most important consideration in awarding contracts for investment management services.

3. Why was the Contract With IDS Not Renewed?

Mr. Carlson criticized the public reason stated by Commissioner Hatch for not renewing the contract with IDS. In a letter dated September 11, 1989 to *Corporate Report* magazine, Commissioner Hatch maintained that the former investment manager's performance was only fair. He said that the manager's performance was less than the yield of commercial banks' securities over each of the last five years. This is a misleading comparison given the differing investment restrictions of the workers' compensation portfolio and commercial banks. In fact, over almost every period it held the contract, the manager outperformed the benchmarks it had agreed upon with the department. Mr. Hatch did not repeat this reason for not renewing the IDS contract to us. In

10 See, for example, Claude Rosenberg, "Reforming Performance", *Institutional Investor* 23, no. 6 (Dec. 1989): 30, and Nancy Belliveau McConnell, "Can Phony Performance Numbers be Policed", *Institutional Investor* 23, no. 7 (June 1989): 91-104.

11 Although not contained in the proposal, the department had complete information on IDS' performance since it was the current fund manager. However, the department did not have comparable performance information on the other two bidders.

fact, he repeatedly told us the issue was not performance, but fees. We have no way to verify whether fees or performance was more important in Mr. Hatch's decision.

We want it to be clear, however, that we are not critical of Mr. Hatch for deciding to reopen the contract to competitive bidding. Periodic open competition for state contracts is good management practice. But the beneficial effects of competition can occur only if there is adequate notice and a rigorous review of the proposals that are received.

4. Did the Bids Contain Adequate Personnel Information?

Mr. Carlson also questioned the absence of personnel data from the proposals. We think his concern is well founded. It would be difficult to judge the qualifications of any of the proposed investment managers solely from examining the background material submitted in the proposals. In particular, the background data submitted by the Dougherty Dawkins firm was insufficient by itself to base a decision on. The proposal did not contain sufficient background on the past investment performance of the proposed portfolio managers. This should not have disqualified Dougherty Dawkins by any means. It should have been one of many things to talk with the firm about during an appraisal process.

As we noted earlier, the department did not check the references of any of the applicants, call them in for interviews, or seek clarifications on any of the bids. We spoke with a number of investment managers about the process by which they got new contracts. Invariably it involved an interview process and generally they said it took months of work to get new accounts. Even the personnel at Dougherty Dawkins were somewhat surprised there were no interviewing or other questions before the contract award.

5. Was the Process Political or Directed to Benefit the Contract Recipient?

One of the allegations made by Mr. Carlson was that the process by which Mr. Hatch awarded the contract to Dougherty Dawkins Portfolio Advisory Service was "political." We thought the most straightfoward way to judge this accusation was to determine the extent to which the people associated with Dougherty Dawkins' Portfolio Advisory Service bid have been or are political supporters of Mr. Hatch.

Mr. Hatch has been for many years an active and visible member of the Democratic-Farmer-Labor (DFL) party. He was the party's chairman from June 1980 until January 1983. On January 3, 1983 Mr. Hatch was appointed by Governor Perpich to be Commissioner of Securities and Real Estate and on

February 24, 1983 he was appointed to the newly established position of Commissioner of Commerce, where he served until January 8, 1990. On January 21, 1990 Mr. Hatch announced that he would seek the DFL candidacy for governor in the November 1990 election.

We reviewed the campaign contributions of people associated with the Dougherty Dawkins firm from 1986 through 1989 and found that they have made contributions to several candidates and political committees, both Independent-Republican (IR) and DFL. In 1987 individuals at Dougherty Dawkins contributed a total of $1,400 to a committee--called the 1990 Fund--which was known to be interested in supporting Mr. Hatch for Governor.[12] Individuals at the firm have contributed larger amounts to other candidates and political committees. Mr. Pint, who told us he considers his political affiliation to be Republican and who served as Banking Commissioner in the IR administration of Governor Quie, gave $300 to the 1990 Fund in 1987.

Based on this pattern of campaign contributions and affiliations and in the absence of other evidence of significant political or financial alignment or support for Mr. Hatch, we do not think that the Dougherty Dawkins firm received the contract because of any political connection to Mr. Hatch.

Nor do we have any evidence that the Dougherty Dawkins firm received the contract because of any other kind of personal benefit being promised to or received by Mr. Hatch. We asked Mr. Hatch and the people who submitted the Dougherty Dawkins bid if there was any understanding that Mr. Hatch would receive any personal benefit or favor if the contract was awarded to Dougherty Dawkins, and we were told that there was no such understanding either stated or implied. And, again, we have no evidence to the contrary.

Mr. Carlson alleged that the process was designed to achieve the decision that was made: to award the contract to the Dougherty Dawkins firm. We cannot answer this allegation with certainty.

Because Dougherty Dawkins did not bid in response to the first RFP it seems clear that Mr. Hatch did not originally design the process to award the contract to Dougherty Dawkins. But after the first bids were rejected, Mr. Hatch's actions and judgements gave a significant advantage to the Dougherty Dawkins/CFS group. First, the limited and informal solicitation process assured that there would be few bidders. Second, Mr. Hatch's call to Mr. Pint gave Mr. Pint and ultimately the Dougherty Dawkins/CFS group a special notice that was extended to no more than three other people, and possibly to no one else. Finally, Mr. Hatch was favorably impressed with the Dougherty Dawkins/CFS group because of personal impressions that had little to do with the bid they submitted. According to his statements to us, Mr. Hatch was impressed with the Dougherty Dawkins firm because he knew of several successful business people who had invested money in the firm. Also, Mr. Hatch made it clear to us that he has a very high opinion of Mr. Pint because of earlier associations. These personal assessments undoubtedly gave an advantage to the Dougherty Dawkins/CFS bid. While it was not inappropriate

12 The 1990 Fund contributed most of its money to Mr. Hatch's campaign finance committee.

for Mr. Hatch to use these judgements in making his decision, he should have engaged in a more active, open and systematic solicitation and review process, which undoubtedly would have brought forth more bidders, as well as extended Mr. Hatch's knowledge and given him a broader basis for his decision.

In short, we do not have any evidence that Mr. Hatch predetermined that the contract would be awarded to Dougherty Dawkins. But the process he directed gave the firm a considerable advantage.

6. Was the Fee Arrangement Appropriate?

Mr. Carlson questioned "the validity of the $130,000 annual service fee to Central Financial Services (CFS) owned by John Morrison and headed by Michael J. Pint." He said CFS receives "over-compensation" for the economic consultation services they provide to Dougherty Dawkins.

The compensation received by CFS was based on a business decision between Dougherty Dawkins and officals at CFS. It is appropriate that the arrangement was disclosed and it should have been fully understood by the Department of Commerce. But we do not think it should have disqualified the Dougherty Dawkins/CFS bid, or even made it less appealing to the department. Dougherty Dawkins was the principal service provider, and while it is odd that they would be willing to assign half of the service fee to CFS for economic consultation services, we do not question their right to make that judgement.

Nevertheless, we are troubled that a significant payment was secured by CFS in part because Mr. Hatch gave Mr. Pint special treatment: he gave a special notice to Mr. Pint. Because the solicitation process was so limited and informal, the phone call Mr. Hatch made to Mr. Pint notifying him of the availability of the contract proved to be of considerable value.

We do not fault Mr. Pint for responding and joining in a bid with Dougherty Dawkins. But we cannot endorse the process that helped him win the contract.

THE INVESTMENT POLICY OF THE ASSIGNED RISK PLAN

In the course of conducting the study we talked with many investment managers. Several of them, including the current and former investment managers raised questions about the restrictions on plan investments. IDS talked with department staff several times about this restriction. When Dougherty Dawkins took over the contract, they convinced the department to make several changes in the investment restrictions. However, the investment managers still regard the investment policies as conservative.[13] The restrictions were imposed, not as the result of the suggestions of investment managers, but by staff at the Department of Commerce.[14]

In particular, the investment managers wondered whether the restriction on credit quality (i.e., Aaa corporate bonds) was necessary. Other insurance companies in the state are required to invest only in so-called "investment grade" bonds (rated Bbb or better). Indeed, Mr. Hatch, when made aware that this restriction was in the state's contract with the investment managers, also believed that it should be changed.

The second major restriction is the maturity of fixed income securities that may be held. The original restriction on IDS's fixed income investments maturity was three years. This resulted in a fixed income portfolio with a duration of about 1.5 years when IDS managed the contract.[15] The current maximum maturity is five years and the portfolio's current duration is about 2.3 years. However, based on the actuary's estimates, the current average weighted maturity of the liability the portfolio is funding, future worker's compensation claims, is approximately 4.6 years.[16]

We also talked with the actuary for the fund. He told us that the department had never talked with them about the investment policy for the fund. He said that they normally do prepare an analysis of future cash flows for their insurance company clients.

The State Board of Investment told us they normally review the investment policy for a portfolio at least every three years. The investment policy for the assigned risk portfolio has never been formally reviewed by the Department of Commerce. We believe that the current restrictions on credit quality and fixed income security maturities are too conservative given the anticipated liabilities, and that these restrictions have most likely cost the portfolio several million dollars in foregone investment returns. As a result, we recommend:

- **The Department of Commerce should contract with its actuarial firm to provide them with an analysis of the future cash flows of the plan. The department should then work with its investment manager to determine the most appropriate investment policy for the plan, taking into account the actuary's estimates of required future cash**

13 At Dougherty Dawkins suggestion, the allowable term of fixed income securities was raised from 3 years to 5 years, and they were allowed to invest in Eurobonds.

14 None of the 1984 proposals called for these restrictions.

15 Duration is a measure of the length of fixed income securities. It is simply the weighted average of the times in the future when interest and principal payments will be received.

16 This estimate is based on the most conservative scenario. It assumes that the fund goes out of business and takes in no new premiums and incurs no new claim liabilities; that it just pays out existing liabilities. In fact, the actuary told us that it was unlikely that the size of the fund would decrease at all in the future if the state maintained roughly the same share of the workers' compensation market in the state. Thus, according to the actuary's estimates, the fund is too heavily weighted towards short term investments. This means, in general, lower returns for the portfolio.

flows. If necessary, the department should contract with an expert in investment management to independently advise them about an appropriate policy.[17]

17 *Public Laws* of 1990, Chapter 450 provides that the State Board of Investment will manage the funds when the current investment management contract expires in May 1991. Therefore, the department should include both the current manager and SBI in its deliberation on a new investment policy.

APPENDIX A

ROGER D. MOE
Senator 2nd District
MAJORITY LEADER
Route #3, Box 86A
Erskine, Minnesota 56535
Phone: 218/574-2216
Room 208, State Capitol
St. Paul, Minnesota 55155
Phone: 612/296-2577

Senate
State of Minnesota

January 17, 1990

Senator John Brandl
Chair, Legislative Audit Commission
306 State Capitol
St. Paul, Minnesota 55155

Dear Senator Brandl:

Enclosed are copies of correspondence from the State Auditor, Arne Carlson, regarding the handling of a state contract by the former Commissioner of Commerce.

Mr. Carlson is requesting that the Legislature investigate these matters. His allegations seem serious and substantive. However, we are not in a position to determine their accuracy or merits. And we do not believe that a standing committee is the appropriate place to deal with his request.

It seems to us that the Legislative Audit Commission is best equipped to examine complicated and controversial questions of the kind raised by Mr. Carlson. Since 1979 it has been the policy of the LAC that all requests of this nature be brought before the full Commission. Therefore, we request that you schedule a meeting to discuss this matter and direct the auditor on how to proceed.

Sincerely,

Roger D. Moe

Roger D. Moe
Senate Majority Leader

Donald Moe

Senator Donald Moe

Duane Benson

Duane Benson
Senate Minority Leader

Gene Merriam

Senator Gene Merriam

cc: Speaker Bob Vanasek
Jim Nobles, Legislative Auditor
Arne Carlson, State Auditor

Enclosures

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STATE OF MINNESOTA

OFFICE OF THE STATE AUDITOR

SAINT PAUL 55103

612-296-2551

ARNE H. CARLSON
STATE AUDITOR

STATE EXECUTIVE COUNCIL
STATE BOARD OF INVESTMENT
LAND EXCHANGE BOARD
HOUSING FINANCE AGENCY
RURAL FINANCE ADMINISTRATION
TREASURER, PUBLIC EMPLOYEES RETIREMENT ASSOCIATION

January 5, 1990

Senator Donald Moe
309 Capitol
St. Paul, Minnesota 55155

Senator Duane Benson
Senate Minority Leader
147 State Office Building
St. Paul, Minnesota 55155

Senator Roger Moe
208 Capitol
St. Paul, Minnesota 55155

Senator Gene Merriam
122 Capitol
St. Paul, Minnesota 55155

Representative Robert Vanasek
Speaker of the House
463 State Office Building
St. Paul, Minnesota 55155

Representative Wayne Simoneau
365 State Office Building
St. Paul, Minnesota 55155

Representative Leo Reding
537 State Office Building
St. Paul, Minnesota 55155

Representative Bill Schreiber
Minority Leader
267 State Office Building
St. Paul, Minnesota 55155

On December 18, 1989, I wrote to the Governor regarding the handling of the $200 million Assigned Risk Plan Fund by the Commerce Department. Governor Perpich has made it clear that he does not intend to investigate this matter at all.

I am therefore making this request directly to you, the leaders of the Legislature, for an investigation into this matter. The reported comments of Commerce Commissioner Michael Hatch justifying his actions in regards to this fund range from the blatantly untrue to the nonsensical. It is my opinion that Commissioner Hatch is hoping to disguise the mismanagement of this fund by relying heavily on the general lack of knowledge regarding institutional fund management.

The issues here are serious, the amount of public money involved substantial, and the entire matter deserves nothing less than a complete public airing. I therefore respectfully request that the Legislature formally investigate this matter.

Warmest regards,

Arne

ARNE H. CARLSON
State Auditor

AHC:mgt
L48

STATE OF MINNESOTA
OFFICE OF THE STATE AUDITOR
SUITE 400
525 PARK STREET
SAINT PAUL 55103

ARNE H. CARLSON
STATE AUDITOR

296-2551

December 18, 1989

The Honorable Rudy Perpich
Governor of the State of Minnesota
Room 130, Capitol Building
St. Paul, Minnesota 55155

Dear Governor Perpich:

A citizen has brought a situation to my attention that I feel warrants immediate investigation and correction by you. The subject of the complaint involves the handling of the Assigned Risk Claims Plan Fund (the fund) by the Department of Commerce.

The Assigned Risk Claims Plan was created by the Legislature to provide workers' compensation coverage to employers unable to obtain private coverage. All insurance carriers writing workers' compensation coverage in the state must contribute to the fund which currently has approximately $200 million in assets.

I have several concerns regarding the procedure followed by the Department of Commerce for the hiring of a new financial manager for the fund. Briefly stated, I question the following:

1. The process utilized by the Department of Commerce in inviting potential bidders. The circumstances indicate that the bid process was directed to benefit the eventual recipient of the contract.

2. The public reason stated for the dismissal of the IDS Advisory Group has little basis in fact.

3. The absense of significant personnel data from the proposal submitted by the eventual bid winner Dougherty Dawkin's Portfolio Advisory Services (PAS).

4. The validity of the $130,000 annual service fee to Central Financial Services (CFS) owned by John Morrison and headed by Michael J. Pint. Ostensibly, they were hired to perform services involving economic analysis. I believe that the fee involved represents substantial over-compensation for this type of service, particularly from individuals lacking significant economic background.

5. The "political" environment that surrounds this entire arrangement.

If I may, let me briefly share with you some of the facts that lead to my conclusions.

Until April of this year, the IDS Advisory Group managed the fund on behalf of the Commerce Department. Due to liquidity needs of this insurance fund, IDS, with the agreement of the Commerce Department, placed approximately 75-80 percent of the fund's monies in quality, fixed income securities with a three-year or less duration. The remaining 20-25 percent of the fund's assets were placed in equity instruments or cash equivalents. Obviously with the bulk of funds invested in three year or less bonds, the total return on the fund will be very much tied to the current interest rates for these instruments. The ability to invest more fund assets in stocks and longer-term debt instruments could greatly enhance the portfolio return while also increasing the risk of loss.

The Commerce Department became disenchanted with the fund's performance in the fall and winter of 1988. The stated reason for this disenchantment was a comparison of the fund's return with the overall return on commercial banks for the same period of time. This is quite simply comparing apples to oranges.

The fact is that the fund's rate of return was dictated by the constraints placed upon the investment of monies and these constraints were accepted by the Department of Commerce. Hence, the rate of return issue appears not to be the real reason for the dismissal of IDS.

Commerce Commissioner Michael Hatch has argued that the fund and commercial banks have similar lists of permissible investments. This is totally irrelevant. The asset mix and short duration of securities necessitated by liquidity needs are the determining factors in the fund's overall return. The fact that commercial banks and the fund are legally permitted to invest in the same type of long-term, short-term, and equity instruments does not make them comparable in any sense. Each entity has a different objective, different philosophy, and different liquidity need. It is these factors that determine each entity's asset mix and, ultimately, their overall investment return. Changing managers without changing the time and quality restrictions on the assets of this fund, will have no significant effect on the fund's return.

It should be further understood that all three bidders for the fund proposed a similar asset mix. IDS indicated that the ratio it had previously developed for the fund of 75-80 percent fixed income to 25-20 percent in equity and cash, was the correct asset mix. First Asset Management did not provide an exact figure, but did state: "The Plan would have a fixed income emphasis with equity exposure for enhancement purposes." PAS, the contract winner, based its fee calculation on the assumption that 90 percent of the portfolio would be fixed income and 10 percent cash and equities.

Relative to the matter involving the process utilized by the Department of Commerce for solicitation of bids, this was accomplished by advertising for bids in the State Register. Copies of these public solicitations to bid are attached hereto. There is no indication in any of these notices as to the size of the fund involved.

It should be remembered that Commissioner Hatch made it abundantly clear that he was dissatisfied that only two bids were received. One would think that at this point he would change methods and seek a more public way of allowing vendors to know that the management of this fund was open to bid. For instance, he could have called the State Board of Investment, of which you are a member, and asked for advice. As you well know, had an open bidding process been conducted, Commissioner Hatch would have had enough bidders to form a double line around the State Capitol. But the Commissioner did not go the public route. He instead rejected the two bids from IDS Advisory Group and First Asset Management, and went back to the utilization of the State Register.

This new activity resulted in three bids being received, with the additional bid being PAS, a firm created by the Dougherty Dawkins Bond firm just for the purposes of this bid. Without interviews, the Commerce Department awarded the contract to PAS in April of this year.

The PAS proposal does not contain enough detail about the suggested managers to allow for meaningful evaluation of their background. Jane Wyatt is the proposed portfolio manager. Of the eight portfolio managers proposed by the three bidders, Ms. Wyatt is the only one who is neither a Chartered Financial Analyst (CFA) nor an M.B.A. Ms. Wyatt is not indicated to be a member of any local, state or national security analyst professional association. Jim Jessup is indicated as the proposed co-manager of the Fund. He is not a CFA or a member of a professional association. He has an M.B.A. degree, however. He is, according to a Commerce Department memo, the manager of the "equity side of the portfolio, which, in the last five years, has never constituted more than 16 percent of the Fund's assets. What is important here is that the background information should be much more extensive than that submitted in the proposal. The people involved may well be talented, but the proposal certainly does not make that clear. PAS was a brand new firm which means it has no history and no investment record that can be analyzed over time. This fact should have compelled the Commerce Department to be extra careful in investigating the background of the people in charge of managing the $200 million portfolio. Unfortunately, there proved to be a surprising rush to qualify and accept the PAS bid, exemplified in the fact that the Securities and Exchange Commission granted PAS registration on March 13, 1989, with PAS amending their application as last as April 11, 1989, and the Commerce Department awarded PAS the bid on this contract which commenced on May 1, 1989.

The Dougherty Dawkins proposal also states that $130,000 per annum will be paid to Central Financial Service (CFS). This fee is for economic analysis. CFS President, Michael J. Pint, has held various financial positions, including CEO for Metro Bank System, Minnesota Bank Commissioner, and positions with the Federal Reserve. Mr. Pint is neither a Chartered Financial Analyst nor an M.B.A. Nothing in his background indicates he is qualified as a financial analyst or economist. A Minnesota Corporate Report article appearing in the September issue this year, indicated that CFS was being paid this amount for "interest rate predictions". Again, there is nothing in Mr. Pint's background that would qualify him as an interest-rate prognosticator. Why does a fund that invests 75-80 percent of its assets in high quality, short-term debt securities need to spend a $130,000 per year for interest rate predictions? Top flight economists would be available for one-fourth of this fee.

The proposal admits that there is no performance history for PAS. There is also no track record indicated for CFS, which, as stated above, receives almost half of the PAS management fee for "economic analysis" services.

The entire handling of this matter by the Commerce Department raises numerous questions. The appearance created by the financial contributions of Dougherty Dawkin's partner, Michael Dougherty, to the 1990 Fund (presumed to be a fund for the campaign activities of Michael Hatch) and the fund-raising activities of CFS owner, John Morrison, on behalf of the 1990 Fund, raise serious concerns of political influence.

I believe enough questions have been raised to warrant a full investigation of this matter. I would strongly suggest that you not allow any of your commissioners to be involved in fund raising activities, particularly when they involve soliciting funds from people in industries they regulate.

The entire scenario outlined above clearly indicates to me that the Commerce Department is a less than competent manager of this fund. It was unable to generate more than three bidders for a $200 million fund. According to the reported remarks of Mr. Hatch regarding commercial banks, the Commerce Department still does not understand the effect on the fund's rate of return necessitated by a policy of investing in short-term, high quality debt instruments. The choice of the Dougherty Dawkins firm on the basis of its low bid alone, ignoring the questionable experience and lack of history of its support entities, is perhaps all that can be expected from a staff unaccustomed to dealing with financial matters on this large scale.

Clearly this fund should be in the hands of the professional staff of the State Board of Investment (SBI). As a member of the SBI, I am sure you are aware that the board handles on a routine basis large sums of money on behalf of State agencies and state retirement plans. At any given time the board is handling over one billion dollars in "liquid" funds. The opportunities for political intrigue and occasions for ineptness due to lack of experience will be obviated if the Assigned Risk Claims Plan Fund is turned over to the professional staff at SBI. This fund is too large to be managed part-time by the Commerce Department.

I strongly urge you to conduct a full inquiry into the activities of the Commissioner of Commerce relative to this matter.

If I can be of further assistance to you, please do not hesitate to call.

Yours truly,

ARNE H. CARLSON
State Auditor

cc: Representative Roger Vanasek
Representative Wayne Simoneau
Representative Leo Reding
Representative Bill Schreiber
Senator Roger Moe
Senator Gene Merriam
Senator Donald Moe
Senator Duane Benson

LIST OF CONTACTS

Appendix B

Arne Carlson, State Auditor
Thomas Gilbertson, State Auditor's Office
David Kenney, State Auditor's Office
Mike Hatch, former Department of Commerce Commissioner
Heidi Strommen, former Department of Commerce employee
Hollice Allen, Department of Commerce
Tammy Wetterling, Department of Commerce
Gary LaVasseur, Department of Commerce
James Miller, Department of Commerce
Kristine Eiden, Department of Commerce
Rose Ortiz, former Department of Commerce employee
Beth Lehman, State Board of Investment
Howard Bicker, State Board of Investment
Doug Gorence, State Board of Investment
Michael Dougherty, Dougherty, Dawkins, Inc.
Mark Landreville, Dougherty, Dawkins, Inc.
Ken Dawkins, Dougherty, Dawkins, Inc.
James Jessup, Dougherty, Dawkins, Inc.
Jane Wyatt, Dougherty, Dawkins, Inc.
George McGunnigle, Jr., Leonard, Street and Deinard
Peter Wattson, Senate Counsel
Mike Pint, Central Financial Services, Inc.
Andy Meuwissen, Workers' Compensation Assigned Risk Plan Review Board
Dennis Ballinger, Workers' Compensation Assigned Risk Plan Review Board
George Klouda, former Workers' Compensation Assigned Risk Plan Review Board member
John Herder, Milwaukee Teleservice Actuarial Consulting Division
John Murphy, First Asset Management
Kevin Underkofler, First Asset Management
Katherine Domler, IDS
Mitzi Malevich, IDS
Bill Berkmeier, IDS
Tom Brakke, IDS
Pam Moret, IDS
Noel Rahn, Investment Advisors, Inc.
Steve Wishart, Washington Square Capital
Larry Fredrickson, Northwestern National Life Insurance

Miles Cohen, Norwest Capital Advisors
John Gibas, Piper Capital Management
Mike Bean, Alliance Capital Management
Mike Brilley, Sit Investments
Morgan Fleming, Lobbyist
Bob Hentges, Lobbyist, Faegre and Benson