

PENSACOLA NEWS JOURNAL

City vs. Brokers - Pension boards set sights on Merrill Lynch

[Kris Wernowsky • March 29, 2009]

Pensacola pension funds are taking aim at Merrill Lynch for what they claim are millions of dollars in losses to employee retirement funds.

The board of trustees of the Firefighters' Pension Fund has filed suit in U.S. District Court in Pensacola against the brokerage company and one of its former senior vice presidents. The board claims bad advice and conflicts of interest led to the plan losing more than \$3 million over seven years.

And the board of the General Pension Fund will consider at a meeting next month whether to sue the brokerage and an ex-vice president over an alleged \$10 million in losses. This board represents city employees who are not firefighters or police officers.

The basic allegation is the same in both instances: Merrill Lynch, which served as investment consultant to the pension funds, and a former senior vice president illegally benefitted at the expense of the funds. The former senior vice president for pension fund consulting is Michael Callaway of Ponte Vedra.

"You're already sailing in rocky waters, and they're the navigator and they're telling you the wrong way to go," said Pensacola attorney David McGee, an attorney for the firefighters' pension board.

Merrill Lynch denied the allegations in court papers responding to the fire board's complaint. Merrill Lynch spokesman Bill Halldin declined to comment, and Callaway's attorney could not be reached.

The two lawsuits come at a time when government officials across the country are struggling with how to sustain increasingly expensive pension plans for retired and disabled municipal employees.

As public dollars shrink, funding is becoming an overwhelming problem. And state law requires municipalities to pay retired employees what has been promised, even if the result is cutting services or raising taxes.

In 2003, the City of Pensacola paid about \$2.9 million a year to fund its three pension funds — general, police and fire. This year, the amount rose to almost \$14 million.

The fire fund, which pays the retirement benefits of 172 former employees, is worth about \$63 million. The general fund, valued at nearly \$80 million, covers 608 former employees. The police fund, valued around \$41 million, covers 122 ex-employees.

The City Council plans to meet Thursday to begin considering what steps may bring local pension expenditures under control.

Wall Street giant

Pensacola's issues with Merrill Lynch, which are separate from the basic issue of funding pension plans, are not unique.

Pensacola attorney Peter Mougey, who's working with McGee, said they are examining Merrill Lynch's interactions with about 50 other government pension boards.

"These boards hired a Wall Street giant in Merrill Lynch to protect their interest, and these people were skimming the cream off the top and lining their pockets with profits," Mougey said.

Edward Siedle, a former SEC attorney, heads Benchmark Financial Services, a private South Florida company that investigates abuse by money managers. Siedle last year began representing the Delray Beach fire and pension board in a \$9 million lawsuit similar to the Pensacola fire board's claims.

The Delray Beach suit is against Citigroup through its Smith Barney subsidiary. Smith Barney was hired as a consultant to the board for nine years. Citigroup says the claim is "without merit."

Siedle said he sounded the alarm in 2002 about pension boards relying heavily on consultants who end up working in their own interests.

Boards often consist of firefighters, police officers and citizens who have no independent expertise, so they offer poor oversight of the financial consulting companies they hire, he said.

The Pensacola firefighters' pension board consists of two firefighters, a retired human resources specialist and two accountants.

"They hire Wall Street managers for their expertise, and these Wall Streeters are using their expertise for their own advantage," Siedle said. "Nobody catches it because it's very arcane."

Merrill Lynch's actions could cost municipal pension funds in Florida between \$700 million and \$1 billion, Siedle said.

It's customary for pension fund boards to have autonomous power on how they spend and invest money, said Bob Lee of the Center for Government Excellence at Florida State University.

"It's both reasonable and customary," he said.

Under scrutiny

Merrill Lynch and Callaway already have come under scrutiny by the U.S. Securities and Exchange Commission.

In January, the SEC settled a claim against Merrill Lynch for breaching its duties to pension fund clients in connection with Callaway. The company paid a \$1 million fine but was not required to admit wrongdoing.

The SEC also filed a complaint against Callaway, 57, who worked with Merrill Lynch from 1976 until 2008. Callaway headed The Callaway Group, a team of 10 Merrill Lynch employees who provided advisory services to about 100 public pension funds in Florida.

Callaway is contesting the allegations and is scheduled to appear at an SEC hearing May 11 in Washington.

Jeffrey Swanson, a financial adviser who worked for The Callaway Group in Ponte Vedra, also settled with the SEC. He was censured but not fined.

In a letter to clients, Callaway defended his work, according to the SEC complaint against him.

"All of our decisions regarding the recommendation of investment management firms are based on the in-depth quantitative and qualitative analysis provided by our 22-member manager research team headquartered in New Jersey,"

Callaway wrote. "Our recommendations are unbiased and made only with our clients' best interest in mind."

Not so, the SEC said.

Despite his assurances, Callaway and his team recommended money managers who were not identified and vetted through Merrill Lynch Consulting Services — a New Jersey consultant service within Merrill Lynch, according to the SEC complaint.

Instead, Callaway pulled his information from a "Callaway short list" of money managers, many of whom were not approved and would not be approved by Merrill Lynch, the complaint said.

Callaway is accused of failing to disclose to the pension funds his relationships with the money managers.

For example:

- He failed to reveal that he used the vacation homes of principals of a money management firm that was on his short list, according to the complaint.
- A money manager directed a large percentage of the Callaway Team's clients' trading to Merrill Lynch. Each time the money manager traded back into Merrill Lynch, Callaway's team and the consulting division received fees, the complaint said.
- Callaway recommended under-performing money managers because they were bringing fees back to Merrill Lynch. If brokers wouldn't trade through Merrill, even if they were better money managers, they wouldn't be selected.

-Terminated contracts

The Pensacola Firefighter's Pension Fund hired Merrill Lynch in 2001 to provide expert analysis and advice. The fund terminated its contract with the brokerage firm last March.

The General Pension Fund contracted with Merrill Lynch beginning in 1993. The relationship ended last June when the company shut down its pension consulting business in Florida.

The firefighters' lawsuit mirrors claims the SEC made against Merrill Lynch and Callaway.

"Merrill was more concerned with generating fees for itself than it was with the plan's best interest," the lawsuit alleges. It also says the pension fund "ended up with money managers who were good for Merrill but not good for the plan."

The suit seeks to recover the allegedly lost \$3 million plus punitive damages.

Mougey, a securities attorney who does most of his work outside of Pensacola, came across the city's name on a list of pension funds possibly affected by what is alleged in the SEC complaint against Merrill Lynch.

"A colleague of mine from South Florida showed me a list of the funds, and I noticed our funds on the list," he said.

Mougey set up a meeting with then-City Councilman Mike Wiggins, now the mayor, city finance director Dick Barker and then-City Manager Tom Bonfield.

The members of the fire pension fund then hired Mougey and McGee.

Expectations

C.C. Elebash, a retired finance professor, sat on the firefighters' pension board in 2001 when the contract with Merrill Lynch and Callaway was approved.

Elebash, who resigned from the board several years ago, wasn't aware of the lawsuit. But he said the financial advisers submitted detailed quarterly reporters about the investments to the board, and the board assumed the company was working in its best interest.

"I think that's a reasonable expectation," he said.

The current board members are:

-- Sam Horton, a retired federal government human resources specialist, who is chairman.

-- Larry Porto, a city fire engineer.

-- Richard Glover, a city fire engineer.

-- Bob Holmes, a certified public accountant.

-- Debbie O'Neil, an accountant.

They were directed by attorneys not to comment on the lawsuit.

Laura B. Josephs, assistant director of the SEC's Division of Enforcement, said in the pension consulting business, clients like the firefighters' pension board hire consulting companies in good faith to work in their best interest. But she said it's the board's ultimate responsibility to know where the money is being invested.

"They're your guide through a very technical competitive area, and you need somebody to act as a go-between," she said. "You need to ask a lot of questions, and you need to be proactive."