Fiduciary Review of Town of Longboat Key Firefighters Retirement System

Benchmark Financial Services, Inc., April, 2011

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I. Executive Summary

Benchmark Financial Services, Inc., was retained by the board of trustees of the Town of Longboat Key Firefighters Retirement System ("the Fund") to review potential conflicts of interest, undisclosed financial arrangements, breaches in professional standards and violations of contracts, involving the fiduciaries, trustees, vendors and service providers of the Fund and officials, officers, and employees of the Town of Longboat Key.

The firm's review is limited to matters related to the Fund, as revealed in documents and materials provided to us various sources including Morgan Stanley, Town employees and legal counsel to the Fund. In conducting the review we interviewed various persons on a limited basis where necessary to supplement our understanding of the documents provided. Given that other relevant information and documentation may exist, it is always advisable that parties knowledgeable regarding the matters under review scrutinize the report in order to determine whether there are any material omissions or misstatements based upon incomplete or inaccurate information.

This report constitutes the firm's expert opinion of the matters reviewed. The report does not constitute legal, financial, accounting or tax advice and should not be relied upon as such. Where additional review and/or action has been deemed advisable, we have so noted. Our recommendations are aimed at improving the overall management of the Fund's investment performance.

By necessity, Benchmark's review largely focuses upon Morgan Stanley since it and its affiliates provide, on a "bundled" basis, fundamental services to the Fund including investment consulting (which includes recommendations for asset allocation, manager

Key Finding:

Benchmark's review largely focuses upon Morgan Stanley since it and its affiliates provide, on a "bundled" basis, fundamental services to the Fund. A preliminary review of the Fund's records revealed longstanding conflicts of interest involving the Fund's investment consultant.

selection and retention, performance monitoring and reporting and investment policy statements); investment management cash management; custodial safekeeping services and securities trading to the Fund.[1]

As discussed in our Interim First Report, a preliminary review of the Fund's records revealed longstanding conflicts of interest involving the Fund's investment consultant that were the subject of an investigation in 2004-2005 when the conflicts were first disclosed by Morgan Stanley to the Town Finance Director. It is important to stress that the conflicts of interest relating to payments from the Fund's investment managers to Morgan Stanley were both acknowledged and disclosed by Morgan Stanley to the Fund. As Fund counsel Robert Sugarman stated in a letter to the board of the Fund dated December 3, 2004, "Since Morgan Stanley has disclosed that it has received payments from your money managers and disclosed that it may have an incentive to select or retain managers that make such payments, the issue of Morgan Stanley's conflicts of interest and independence arises."[2]

Further, in the words of Sugarman, "Of particular concern is the requirement of Section 175.071(b)(a), Florida Statutes that requires your consultant to be "independent." In particular, subsection (6)(b) requires that the consultant "is not associated in any manner with the money manager for the pension fund." Morgan Stanley's admitted conflicts of interest and admitted receipt of payment from your money managers raises the issue of whether Morgan Stanley is independent, as required by Chapter 175. …Morgan Stanley's disclosures, when compared to the independence requirements of the statute, raise a question which must be answered."

The focus of the 2004-2005 investigation was solely upon conflicts related to certain payments amounting to approximately $209,000 paid by the Fund's investment managers to Morgan Stanley. The 2004-2005 investigation ended with no formal conclusions by Mr. Sugarman and therefore in the First Interim Report we recommended a broader inquiry regarding such payments and any other payments flowing from the Fund's investment managers to Morgan Stanley.

During the course of our review of the overall Fund, we identified additional significant compliance issues related to the services provided by Morgan Stanley to the Fund. We were also contacted by the U.S. Department of Labor regarding compensation arrangements, conflicts of interest and disclosure practices related to Morgan Stanley.

Our review of the trade confirmations of the Fund provided by Morgan Stanley reveals both principal transactions and agency cross transactions. According to the SEC, "Section 206(3) of the Investment Advisers Act of 1940 prohibits an adviser acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client ("principal transaction"), without notifying the client in writing, and obtaining the client's consent before

[1] Since Morgan Stanley provided similar services to the two other Longboat Key pensions through 2009, certain issues discussed herein may be relevant to those plans.
[2] Exhibit A.

the completion of the transaction. Notification and consent for principal transactions must be obtained separately for each transaction. Rule 206(3)-2 under the Advisers Act permits an adviser to act as broker for both its advisory client and the party on the other side of the brokerage transaction ("agency cross transaction") without obtaining the client's prior consent to each transaction, provided that the adviser obtains a prior consent for these types of transactions from the client."

The relevant agreement between the Fund and Morgan Stanley specifically prohibits both principal and agency cross transactions. Therefore such transactions appear to violate both the agreement with the Fund, as well as the federal statute applicable to investment advisers. Further, our review of the trade confirmations of the Fund provided by Morgan Stanley reveals commissions related to trades in apparent violation of the terms in the agreement between the Fund and Morgan Stanley.

Our review of the custodial arrangement between the Fund and Morgan Stanley Trust identifies two potential compliance issues regarding whether the arrangement satisfies the third party custodian requirement in Florida Statutes 112.661(10) and whether holding Fund assets in an account registered in the name of a "nominee" at Morgan Stanley Trust, as opposed to in the name of the Fund, is permissible under that statutory provision. Further, the sweep of the Fund's uninvested cash balances into a money market fund managed by an affiliate of the investment consultant appears to be impermissible under Florida Statutes Section 175.

Numerous amendments to the Investment Policy Statement of the Fund are recommended to (1) more accurately reflect the Fund's existing investment process; (2) clarify reporting of and standards for evaluating the Fund's overall investment performance; and (3) enhance protection of the Fund. It is recommended that the Statement be amended to provide: (a) the investment consultant shall be held to ERISA fiduciary standards; (b) in order to be considered to manage Fund assets, investment managers must participate in the Morgan Stanley Access program; (c) Morgan Stanley may terminate a manager from the Morgan Stanley Access program without consulting the board and if an investment manager of the Fund is terminated by Morgan Stanley from the Access program the Fund will be required to select a new manager. It is also recommended that the Statement be amended to state the board will regularly review material changes regarding the investment consultant's organization, investment philosophy, personnel or disciplinary/regulatory standing, as well as conflicts of interest involving the investment consultant. Finally, and perhaps most important, the board should consider whether to amend the Statement to specifically state which Russell universe the Fund's overall return is to be measured against.

A review of the overall investment performance of the Fund as of December 31, 2010 as compared to one of the two standards established for evaluating the overall Fund in the Expected Annual Rate of Return section of the Investment Policy Statement, i.e., a customized index composed of the various market indices weighted by the strategic asset allocation of the Fund's assets, indicates that after deducting investment and transaction costs since inception

the Fund has underperformed by approximately 56 basis points. Over the past ten years underperformance of the Fund against this benchmark has been 1.25%.[3]

However, investment performance of the overall Fund as compared to the second return standard established in the Investment Policy Statement, i.e., the median of the upper one third or median of the upper one half of the Russell universe (the top 16% or 25% respectively of investment managers), is likely to be **significantly worse** since the top 16% or 25% of active investment managers are most likely to have significantly outperformed their respective benchmarks. For example, investment managers in the 25th percentile have over the past ten years outperformed the Russell 2000 by approximately 400 basis points.[4] Since the standards for evaluating overall investment performance of the Fund established in the Investment Policy Statement are unclear, it is impossible for the board (or anyone else) to determine how the Fund has performed against those standards.

We have recommended that, in order to obtain a complete evaluation of the investment performance of the Fund the board request from Morgan Stanley the investment performance of the Fund as measured against both return standards stated in the Expected Annual Rate of Return section of the Investment Policy Statement. We were unable to locate any reports comparing Fund performance to both of these return standards.

Our repeated requests for additional information regarding any compensation directly or indirectly paid to Morgan Stanley or any of its employees or agents by the Fund's investment managers, including information regarding the nature and amounts of any such payments and whether such payments have continued over the years, resulted in no additional information from Morgan Stanley regarding such payments. As mentioned below, Morgan Stanley has indicated that it does not believe it has an obligation to provide such information. It is our recommendation that the board determine whether the information provided by Morgan Stanley to date regarding the amounts and nature of payments to Morgan Stanley from the Fund's investment managers is adequate to demonstrate compliance with applicable fiduciary standards and law.

In light of the compliance issues stated above related to the Fund's fundamental operations such as investment consulting, trading and custody we strongly recommend that the board consider whether to request one or more written legal opinions stating that the Fund is in compliance with applicable law. Based upon conversations with the State of Florida Division of Retirement, it is our understanding that non-compliance with applicable law, such as 175.071(b)(a) Florida Statutes, can potentially have serious financial consequences for the Fund, its participants and others, including taxpayers, such as jeopardizing the Fund's receipt of premium tax monies. That

[3] As of December 31, 2010, on a 1 and 2 year basis the Fund has significantly underperformed; on a 3 year basis the Fund has slightly underperformed and on a 5 and 7 year basis the Fund has slightly outperformed this benchmark.

[4] Data provided by eVestment Alliance as of March 31, 2011, based upon 129 observations.

is, the consequences of noncompliance may be significant. Further we recommend that the board consider whether a Fund Compliance Director should be designated to monitor compliance going forward.

We also recommend that the board regularly review the disciplinary records related to Morgan Stanley and the individual Morgan Stanley investment consultants annually, including the FINRA BrokerCheck records, as well as the Form ADV disciplinary disclosures.

Finally, we recommend that the board review whether Sugarman & Susskind, P.A. may have a conflict of interest with respect to matters discussed herein and consider whether information from Sugarman & Sussman, P.A. regarding class action and individual lawsuits alleging pension consultant conflicts of interest involving numerous Florida public funds may be of educational value.

II. Investment Consultant Issues

A. Historic Investment Consulting; Investment Management and Custody Arrangements

The Fund entered into an Agreement for Investment Performance Monitoring and Advisory Services dated October 1, 1999 with Salomon Smith Barney ("SSB"). The fee stated in the agreement was $6,000.00 payable quarterly in arrears and the agreement contemplated (or at a minimum provided a mechanism for) payment of the fee by means of securities trades executed through SSB. While the agreement provided that SSB acknowledged it was a fiduciary of the Fund, the payment arrangement involved a conflict of interest since the firm received trading compensation from the investment managers it recommended to the Fund. Section E.1 of the Agreement contained a representation that the investment consulting firm is not "in any way compensated by nor does (it) have any affiliation whatsoever with any Plan investment manager." This language tracks the requirements of Section 175.071(b)(a), Florida Statutes regarding the independence of consultants.

In a letter dated July 25, 2000, John E. Pether, the Fund's financial consultant at SSB, stated that he had decided to withdraw from providing consulting services to the municipal pension market and accordingly, SSB was terminating its relationship with the Fund.

According to the minutes of the meeting, on December 1, 2000, a joint meeting of the Town's three retirement system boards was convened for the purpose of expediting the interviewing and the selection of a new investment consultant to fill a vacancy which occurred when the previous performance monitor, SSB, who served all three boards, resigned. Three investment consulting firms, Bogdahn Consulting; Dahab Consulting and Morgan Stanley each presented an oral report and answered questions from trustees. There was a consensus for all three Boards to employ one performance monitor jointly and Morgan Stanley was selected.

Of the three firms that presented, Bogdahn and Dahab were independent consultants apparently unaffiliated with any broker-dealer and not subject to any related conflicts of

interests.[5] Only Morgan Stanley was a broker-affiliated consultant subject to such potential conflicts. There is no mention in the minutes of the meeting of any discussion of pension consultant conflicts of interest.

At the December 1, 2000 joint meeting, after being hired, Morgan Stanley stated the firm would also be willing to perform the duties of the custodian free of charge; at that time the Fund paid a custodial fee of 8.4 basis points, according to the minutes of the meeting.

The Fund entered into an Agreement for Investment Performance Monitoring and Advisory Services dated January 25, 2001 with Dean Witter Reynolds.[6] This agreement was substantially similar to the previous agreement with SSB and provided for payment of the investment consulting fee through trading commissions from the Fund's managers. Section E.1 of this 2001 agreement between Morgan Stanley and the Fund contained a representation that the investment consulting firm is not "in any way compensated by nor does (it) have any affiliation whatsoever with any Plan investment manager."

While we have not been provided with the relevant agreement, it appears that Wells Fargo/Norwest served as an independent third party custodian of the assets of the Fund at this time, unaffiliated with the investment consultant and investment managers of the Fund. Rittenhouse apparently was the sole investment manager to the Fund.

In 2001 and 2002, the Fund's investment consulting, investment management and custody arrangements changed significantly, as did the payment arrangements. While in the past investment consulting, investment management and custody had been separated, Morgan Stanley was eventually retained to provide all such services, in addition to securities trading.

Two months after Morgan Stanley had been selected as the investment consultant for all three Town funds and after Morgan Stanley had offered to provide custodial services for free, at the March 1, 2001 meeting, the minutes indicate "Mr. Sugarman stated that fees charged by Wells Fargo were 2-3 times greater than those charged by other custodians. He recommended Morgan Stanley provide fee schedules from other custodians for comparison at the next quarterly meeting and for a change of custodians to be considered at that meeting."

According to the minutes of the May 23, 2001 meeting "Joe Carter distributed copies of the Investment Consulting Services Manager Review, and discussed findings of his custodian research. Fiduciary International Trust and Wachovia Fiduciary Trust were contacted; neither trust company was interested. However, Stanley Morgan (Morgan Stanley) Trust Department

[5] For example, The Bogdahn Group website at http://www.bogdahnconsulting.com/ states, "We have never engaged in soft-dollar fee arrangements and are not affiliated with any Investment Management firms or other service providers." Dahab Associates, Inc. claims to receive no revenue from any source other than its consulting clients.

[6] Exhibit B.

would perform custodial services for six (6) basis points. Chairman Ross recommended Stanley Morgan (Morgan Stanley) provide a service/management proposal."

According to the minutes of the August 22, 2001 meeting, the Board accepted Morgan Stanley's recommendation to hire two additional money managers. A custodian interested in providing services, Salem Trust Company, had been located. Salem Trust and Morgan Stanley Trust made presentations regarding custody; Morgan Stanley offered a wrap-fee program that included custodial, brokerage, investment consulting, and management services that the Board accepted.

B. Current Investment Consulting; Investment Management and Custody Arrangements

Pursuant to a Client Service Agreement dated May 22, 2002, the Fund retained Morgan Stanley DW Inc. to provide investment consulting services, brokerage and custody services.[7]

The Agreement states that the managers "deemed suitable" by Morgan Stanley for the Fund may be affiliated with Morgan Stanley and will be selected "from among those participating in the Morgan Stanley Access program." In other words, investment managers recommended by Morgan Stanley for the Fund will be limited to only those that are either affiliated with Morgan Stanley or have, at a minimum, an existing business relationship with the firm through participation in the Access program. As a result, investment managers who may have superior or comparable performance who do not participate in the Morgan Stanley Access program may not be selected.

For whatever reason, this Agreement did not include the representation that appeared in the previous agreements that the investment consulting firm is not "in any way compensated by nor does (it) have any affiliation whatsoever with any Plan investment manager."[8]

The Agreement states that "the sole standard of care imposed on Morgan Stanley by this Agreement shall be the standards for conduct set for the in Section 661(4) of the Act." Florida Statutes 112.661(4) refers to "the fiduciary standards set forth in the Employee Retirement Income Security Act of 1974 at 29 U.S.C. s. 1104(a)(1)(A)-(C)."

C. Securities Trading

According to the Morgan Stanley Client Service Agreement dated May 22, 2002, Morgan Stanley will provide brokerage services to the Fund with respect to the Fund's accounts. The Agreement contemplates that all or virtually all securities trading related to the Fund will be undertaken by Morgan Stanley; in the Agreement the Fund instructs the investment managers to effect the

[7] Exhibit C.

[8] As mentioned in the Interim First Report, the December 29, 2004 letter from Mr. Sugarman to James A. Link, Executive Director of Morgan Stanley's Consulting Services Group requesting a legal opinion from the firm referenced language in the firm's 2001 contract with the Fund that the firm is not "in any way compensated by nor does (it) have any affiliation with any Plan investment manager." This representation was not included in the 2002 Morgan Stanley Client Service Agreement which was operative in 2004 when the letter to Link was sent.

trades through Morgan Stanley. Commissions related to these trades will be generally included in the "program fee" paid Morgan Stanley, as discussed more fully below. Only securities trades that are not executed through Morgan Stanley will be subject to separate commissions and charges.

Section 2 (d) of the Agreement states at that Morgan Stanley will not execute any "agency cross transactions" or "transactions in which Morgan Stanley would be acting on a principal basis."

Agency cross transactions are transactions in which Morgan Stanley or an affiliate acts as broker for the parties on both sides of the transaction, i.e., both buyer and seller. According to Morgan Stanley, in an agency cross transaction "Morgan Stanley or an affiliate may receive compensation from parties on both sides of such transactions (the amount of which may vary) and, as such, Morgan Stanley and any such affiliate will have a potentially conflicting division of loyalties and responsibilities."[9]

Trading on a principal basis by definition involves self-dealing. In a principal trade, a securities firm sells stocks or bonds to a client directly from its own inventory at an undisclosed profit. Due to the conflicts of interest involved and related dangers, fiduciaries are generally prohibited from dealing with clients on a principal basis.

According to the SEC, "Section 206(3) of the Investment Advisers Act of 1940 prohibits an adviser acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client ("principal transaction"), without notifying the client in writing, and obtaining the client's consent before the completion of the transaction. Notification and consent for principal transactions must be obtained separately for each transaction. Rule 206(3)-2 under the Advisers Act permits an adviser to act as broker for both its advisory client and the party on the other side of the brokerage transaction ("agency cross transaction") without obtaining the client's prior consent to each transaction, provided that the adviser obtains a prior consent for these types of transactions from the client, and complies with other, enumerated conditions. The rule does not relieve advisers of their duties to obtain best execution and best price for any transaction. A principal or agency cross transaction executed by an affiliate of an adviser is deemed to have been executed by the adviser for purposes of Section 206(3) and Rule 206(3)-2."[10]

An SEC Study on the Fiduciary Duty of Investment Advisers and Broker-Dealers released January 21, 2011 discusses, in part, current issues related to principal trading under a fiduciary standard and related conflicts of interest.[11]

As explained by Jason Zweig of the Wall Street Journal in a recent article, "Many investors think of the broker's commission as the cost of buying a security, but that is just the

[9] Exhibit D. Disclosure Document for Morgan Stanley Smith Barney LLC, November 2010, page 32.
[10] http://www.sec.gov/divisions/investment/iaregulation/memoia.htm
[11] http://www.sec.gov/news/studies/2011/913studyfinal.pdf

beginning. Your brokerage firm may act as a "principal," selling you securities it already holds. If you are buying, a principal can charge you more for the security than it paid; this take is known as a markup. If you are selling, the firm can buy from you for less than it could resell the security for; that vigorish is called a markdown. Finra has long held that markups generally should be 5% or less. That, unfortunately, has led many brokers to assume that any cut of up to 5% is acceptable."[12]

According to Morgan Stanley, "Certain clients may maintain accounts at MSSB or its affiliates for which MSSB or its affiliates do not act as an investment adviser but rather as a broker-dealer. MSSB or its affiliates may enter into brokerage transactions as principal and, as a result, a potential conflict may arise between the client's interests and the interests of MSSB or its affiliates in executing transactions as a broker-dealer. As a broker-dealer, MSSB or its affiliates may collect transaction fees, commissions, an asset-based fee or a fixed fee separate from any Program fee."[13]

In order to review compliance with the trading restrictions in the Client Service Agreement, on January 4, 2011, we requested from Morgan Stanley copies of any Morgan Stanley trade confirmations, tickets and blotters related to the Fund, including whether each trade was undertaken on an agency or principal basis and any commissions related to trades.[14]

In a letter dated February 4, 2010 Allison Patton of Morgan Stanley's Legal and Compliance Division responded to the request for trade confirmations indicating that "I have been advised that all transactions in the Firefighters Pension Fund Access accounts were executed on an agency basis." She went on to state, "If you still need copies of the confirmations, please let me know."[15]

In an email dated February 9, 2010, we advised Patton that we still needed copies of the trade confirmations. In a letter dated February 18, 2011, which included as an enclosure a CD containing certain trading records, Patton stated, "After quickly reviewing the confirmations,

[12] Will New Rules Stop Brokers From Nibbling on Your Returns, Jason Zweig, Wall Street Journal, March 26, 2011.
[13] Exhibit D. Disclosure Document for Morgan Stanley Smith Barney LLC, November 2010, page 32.
[14] Note that while the Client Service Agreement states that Morgan Stanley will send confirmation of transactions executed by Morgan Stanley for the Fund's accounts to the Fund, in a Confirmation Election and Authorization Form dated May 22, 2002, the Fund elected not to receive daily confirmation of each transaction executed by Morgan Stanley and in lieu thereof to receive a Periodic Confirmation Statement and/or bulk mailing of all transactions. It does not appear that the confirmations are reviewed by the board when, if ever, received for compliance purposes.

[15] Exhibit E.

there appear to be a few Treasury redemptions coded as principal trades, but the remainder are coded as agency transactions."[16]

In an email dated March 2, we asked Patton, "Has Morgan Stanley executed any agency cross transactions in any of the Longboat Firefighters accounts?" We have not received a response to that inquiry.

Our review of the trade confirmations provided by Morgan Stanley indicates certain of the confirmations did not include important information on the front side of the confirmation, such as execution codes, required to determine compliance.[17] Certain of the confirmations which provided adequate front side information were accompanied with copies of explanations and conditions stated on the reverse side of the confirmations. These reverse side disclosures which explain the execution codes, charges and fees disclosed on the front side of the confirmation are required in order to review the confirmations for compliance purposes. Other confirmations were not accompanied by copies of reverse side disclosures and therefore could not be reviewed for compliance. Further complicating matters, the reverse side disclosures accompanying different confirmations provided different explanations of significant items such as execution codes.

For example, with respect to certain fixed income and equity securities trades bearing an execution code of "P" or "5," the disclosure on the reverse side of the confirmation indicates "Morgan Stanley served as agent for both buyer and seller charging each the customary commission."[18] These transactions appear to be agency cross transactions which are specifically prohibited under the Client Service Agreement between Morgan Stanley and the Fund. Certain equity trade confirmations bearing an execution code of "5" which appear to be agency cross transactions indicate that the Fund has been charged a commission.[19]

With respect to many other fixed income and equity trade confirmations, it is unclear whether the "P" execution code indicates an agency cross transaction because the reverse side disclosure has changed and states that the P execution code simply indicates that Morgan Stanley acted as agent with respect to the trade; the reverse side disclosure accompanying these confirmations no longer provides an execution code alternative indicating transactions where Morgan Stanley acts as agent for both buyer and seller.[20]

As acknowledged by Patton of Morgan Stanley in her second letter, certain fixed income trades were executed on a principal basis.[21] These fixed income transactions appear to be principal transactions which are prohibited under the Client Service Agreement between Morgan Stanley

[16] Exhibit F.
[17] Exhibit G.
[18] Exhibit H.
[19] Exhibit I
[20] Exhibit J.
[21] Exhibit K.

and the Fund. Certain equity trade confirmations disclose a related commission.[22] Again, the Client Services Agreement indicates that there are generally no commissions related to trades executed by Morgan Stanley. With respect to certain confirmations other material information such as principal amount, commission and net amount was illegible when viewed electronically but apparently are legible when the confirmations are subsequently printed.

In summary, the relevant agreement between the Fund and Morgan Stanley specifically prohibits principal and agency cross transactions. Therefore any such transactions executed by Morgan Stanley on behalf of the Fund appear to violate both the agreement with the Fund and the Investment Advisers Act of 1940, the federal statute applicable to investment advisers; transactions executed by Morgan Stanley involving commissions appear to violate the terms in the agreement between the Fund and Morgan Stanley.

Recommendation: The board should determine whether Morgan Stanley is in compliance with the prohibitions in the Agreement regarding agency cross transactions and principal transactions, as well as whether any commissions were charged related to any trades.

Recommendation: The Board should regularly receive, review and retain print copies of the Fund's securities trading confirmations in order to monitor compliance with any relevant contracts and applicable law.

D. Custody of Assets

As mentioned earlier, prior to 2002 the Fund utilized the services of a custodian independent of the investment consultant, brokers and investment managers. Use of an independent custodian provides an additional layer of protection to pensions by, for example, reducing the potential for undisclosed compensation related to a plan's assets and certain conflicts of interest. Further, Florida Statutes 112.661(10) state that the investment policy of any local retirement system or plan shall provide that the securities be held by a third party custodian.

Today Morgan Stanley Trust serves as custodian to the Fund pursuant to a Custodial Services Agreement dated May 22, 2002.[23] This Custodial Services Agreement states that Morgan Stanley Trust's fees for services pursuant to the Custodial Services Agreement shall be included in the fees charged to the client pursuant to the Client Services Agreement between Morgan Stanley, an affiliate of Morgan Stanley Trust, and the Client.

According to the Custodial Services Agreement, the assets held in the Fund's accounts will be registered in the name of a nominee. A "nominee account" is a type of account in which a stockbroker holds shares belonging to clients. In such an arrangement shares are said to be held in street name.[24]

[22] Exhibit L.
[23] Exhibit M.
[24] Definition of "nominee name," investopedia.com.

According to Florida Statutes 112.661(10) the investment policy statement should provide that "securities should be held with a third party, and all securities purchased by, and all collateral obtained by, the board should be properly *designated as an asset of the board* (emphasis added)." The custodying of the Fund's assets in an account registered in the name of a nominee, as opposed to the name of the Fund, appears to raise an issue of compliance with applicable Florida statutes.

According to the Client Services Agreement dated May 22, 2002, Morgan Stanley will, *to the extent permitted by applicable law (emphasis added)*, temporarily "sweep" all uninvested cash balances into a money market fund managed by an affiliate of Morgan Stanley and Morgan Stanley Trust, which will pay a money management fee and distribution fees to affiliates of Morgan Stanley. It is stated that the Fund will pay a proportionate share of the expenses of the money market fund *to the extent permitted by applicable law (emphasis added).*

Since the Morgan Stanley affiliated money market fund is clearly "associated" with Morgan Stanley, it appears that the cash sweep arrangement stated in the Client Services Agreement violates the requirement in Florida Statutes Section 175 that an independent investment consultant not be associated with any investment manager to the Fund.

Finally, the quality of custodial services provided by Morgan Stanley Trust to the Fund has been harshly criticized in recent years. According to minutes of the meeting on March 25, 2009, Town Finance Director Tom Kelley "requested the Board issue a RFP for an Investment Manager and for custodian services; custodian services consultant Morgan Stanley Trust was impossible to deal with; errors were discovered on a consistent basis." At that meeting, Joe Carter, a Morgan Stanley representative, "responded to comments regarding Morgan Stanley Trust with respect to the many errors made, and was in agreement that they should be fired."

Recommendation: The board should consider whether the custodial arrangement with Morgan Stanley Trust complies with the third party custodian requirement in Florida Statutes 112.661(10).

Recommendation: The board should consider whether holding Fund assets in an account registered in the name of a nominee at Morgan Stanley Trust, as opposed to being held in the name of the Fund, is permissible under Florida Statutes 112.661(10).

Recommendation: The board should consider whether the sweep of the Fund's uninvested cash balances into a money market fund managed by an affiliate of Morgan Stanley is permissible under Florida Statutes Section 175.

Recommendation: The board should consider whether the quality of custodial services provided by Morgan Stanley Trust is satisfactory.

E. Investment Policy Statements

The Client Services Agreement dated May 22, 2002 states that Morgan Stanley will provide the Fund with an Investment Policy Statement of Investment Objectives and Guidelines to conform with Section 661 of the Florida Protection of Public Employee Retirement Benefits Act, Florida Statutes, Title X, Chapter 112.

Florida Statutes 112.661 generally states that "investment of the assets of any local retirement system or plan must be consistent with a written investment policy adopted by the board. Such policies shall be structured to maximize the financial return to the retirement system or plan consistent with the risks incumbent in each investment and shall be structured to establish and maintain an appropriate diversification of the retirement system or plan's assets."

While the May 26, 2010 Investment Policy Statement indicates, consistent with Chapter 112, that all assets shall be held by a third party custodian and all assets shall be properly designated as an asset of the Fund, as discussed earlier it is unclear whether the Fund's custodial and nominee name arrangements comply with the statute.[25]

The Investment Policy Statement, as required by Chapter 112.661(4), describes the level of prudence and ethical standards to be followed by the board in carrying out its investment activities with respect to the Fund. The board in performing its investment duties shall comply with the fiduciary standards set forth in the Employee Retirement Income Security Act of 1974 ("ERISA") at 29 U.S.C. s. 1104(a)(1)(A)-(C). The Investment Policy Statement also expressly provides that the investment managers are fiduciaries.

As mentioned earlier, the Client Service Agreement dated May 22, 2002 between Morgan Stanley and the Fund states that "the sole standard of care imposed on Morgan Stanley by this Agreement shall be the standards for conduct set forth in Section 661(4) of the Act." In order to further protect the Fund, it may be advisable to amend the Investment Policy Statement to expressly provide that in addition to the board and investment managers, the investment consultant shall be held to ERISA fiduciary standards.

The Investment Policy Statement does not indicate under XIII. Internal Controls, A. Selection of Managers that one of the minimum criteria investment managers must meet in order to be considered to manage Fund assets is that they participate in the Morgan Stanley Access program. Further, the Investment Policy Statement does not provide that Morgan Stanley, as opposed to the board, may terminate a manager from the Morgan Stanley Access program without consulting the Fund and that if any of its investment managers is terminated by Morgan Stanley from the Access program the Fund will be required to select a new manager.

The Investment Policy Statement does not indicate that the board will regularly review material changes regarding the investment consultant's organization, investment philosophy, personnel

[25] Exhibit N.

or disciplinary/regulatory standing. The Investment Policy Statement does not indicate that the board has adopted any internal controls with reference to the selection and review of investment consultants.

Given the impact investment consultants may have upon funds' investment performance and the fact that, as here, investment consultants often draft the Investment Policy Statements of their clients, it is advisable that the Investment Policy Statement of a Fund include provisions related to due diligence, review, monitoring and replacement of the investment consultant, as well as the investment managers. Where the investment consultant is subject to conflicts of interest involving the investment managers and/ or securities trading, the Investment Policy Statement should include safeguards to address such conflicts.

The March 23, 2001 Investment Policy Statement, under Expected Annual Rate of Return, indicates that over a complete market cycle (defined as 3-5 years) the Fund's overall annualized total return after deducting investment and transaction costs should perform above the median of the *upper one third* of the Russell universe and above a customized index composed of the various market indices weighted by the strategic asset allocation of the Fund's assets (emphasis added).[26] In the February 21, 2007 and May 26, 2010 Investment Policy Statements the Expected Annual Rate of Return language is modified to state that the Fund should perform above the median of the *upper one half* of the Russell universe (emphasis added).

The Investment Policy Statements do not indicate which Russell universe the annualized total return of the Fund is measured against. It is unclear whether the investment performance of the Fund is compared against a universe of investment managers or a universe of pensions.

Recommendation: The board should consider whether to amend the Investment Policy Statement to provide that the investment consultant shall be held to ERISA fiduciary standards.

Recommendation: The board should consider whether to amend the Investment Policy Statement to provide that in order to be considered to manage Fund assets, investment managers must participate in the Morgan Stanley Access program.

Recommendation: The board should consider whether to amend the Investment Policy Statement to provide that Morgan Stanley may terminate a manager from the Morgan Stanley Access program without consulting the board and if an investment manager of the Fund is terminated by Morgan Stanley from the Access program the Fund will be required to select a new manager.

Recommendation: The board should consider whether to amend the Investment Policy Statement to provide that the board will regularly review material changes regarding the investment consultant's organization, investment philosophy, personnel or

[26] Exhibit O.

disciplinary/regulatory standing, as well as conflicts of interest involving the investment consultant.

Recommendation: The board should consider whether to amend the Investment Policy Statement to specifically state which Russell universe the Fund's overall return is to be measured against.

F. Investment Performance of the Fund

As mentioned in the Interim First Report, conflicts of interest at investment consulting firms that recommend money managers to plan sponsors and monitor and report on manager performance were found to result in substantial financial harm to plans by the Government Accountability Office ("GAO") in a 2007 report.[27] In its report the GAO quantified the harm a conflicted adviser to a plan can cause. "Defined Benefit plans using these 13 consultants (with undisclosed conflicts of interest) had annual returns generally 1.3% lower ... in 2006, these 13 consultants had over $4.5 trillion in U.S. assets under advisement," the report stated.

Since inception of the relationship with Morgan Stanley, the number of the Fund's investment managers has increased from one to seven. All of the Fund's investment managers are active managers, i.e., managers who seek to outperform the market; none of the managers are passive or index managers, i.e. managers that seek to replicate the market performance. All of the Fund's managers are participants in the Morgan Stanley Access program.

As discussed above, over the years the Investment Policy Statements in the Expected Annual Rate of Return section have indicated that over a complete market cycle (defined as 3-5 years) the Fund's overall annualized total return after deducting investment and transaction costs should perform both (a) above the median of the upper one third (or subsequently above the median of the upper one half) of the Russell universe; and (b) above a customized index composed of the various market indices weighted by the strategic asset allocation of the Fund's assets. The return benchmarks for each asset class stated elsewhere in the Investment Policy Statements are not and have never been exclusively Russell indices.

A review of the overall investment performance of the Fund as of December 31, 2010 indicates that since inception after deducting investment and transaction costs of 87 basis points the Fund has underperformed a customized index composed of the various market indices weighted by the strategic asset allocation of the Fund's assets by approximately 56 basis points. Over the past ten years underperformance of the Fund against this benchmark has been greater at 1.25%. On a 1 and 2 year basis the Fund has significantly underperformed; on a 3 year basis the Fund has slightly underperformed and on a 5 and 7 year basis the Fund has slightly outperformed this benchmark. Again, this is but one of the two return standards for the Fund stated in the Investment Policy Statement. These net performance figures do not include investment advisory

[27] Defined Benefit Pensions: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges, GAO, June 28, 2007

fees related to the sweep of the Fund's uninvested cash into any Morgan Stanley money market funds (which may slightly reduce the Fund's net return). The gross and net investment performance returns as presented below are based upon performance reports prepared by Morgan Stanley.

	1 Year	2 Years	3 Years	5 Years	7 Years	10 Years	Since Inception	Inception Date
TOTAL FUND GROSS	**11.81**	**14.07**	**1.69**	**5.24**	**5.82**	**2.93**	**3.05**	**01/01/2000**
BENCHMARK	12.07	15.34	0.90	4.25	4.79	3.28	2.72	
TOTAL FUND NET	**10.85**	**13.10**	**0.80**	**4.33**	**4.90**	**2.03**	**2.16**	**01/01/2000**
BENCHMARK	12.07	15.34	0.90	4.25	4.79	3.28	2.72	

Performance of the overall Fund compared to the median of the upper one third or median of the upper one half of the Russell universe, i.e., the second of the two overall Fund return standards stated in the Investment Policy Statement, is impossible to evaluate since the Investment Policy Statement of the Fund does not indicate which Russell universe is utilized for calculating the overall performance of the Fund. Further, the return benchmarks for each asset class stated in the Investment Policy Statements are not and have never been exclusively Russell indices. We have been unable to locate any statements from Morgan Stanley comparing the Fund's overall investment performance against both return standards established in the Investment Policy Statement. We have, through Chairman Tanner, requested such performance information from Morgan Stanley on behalf of the board.

However, investment performance of the overall Fund as compared against the median of the upper one third or median of the upper one half of investment managers (i.e., the top 16% or 25% respectively of investment managers) in any Russell universe may be far worse since the top 16% or 25% of active investment managers are most likely to have significantly outperformed their respective benchmarks.

For example, the table below indicates that over the past 10 years as of March 31, 2011, the 25th percentile of investment managers outperformed the Russell 1000 Growth; Russell 1000 Value and Russell 2000 indices by approximately 200 basis points.[28]

[28] Source: eVestment Alliance

Benchmark	**10-year return**	**25th percentile return**	
Russell 1000 Growth	2.99	5.01	(186 observations)
Russell 1000 Value	4.53	6.45	(167 observations)
Russell 2000	7.87	11.88	(129 observations)

Again, since the standards for evaluating overall investment performance of the Fund established in the Investment Policy Statement are unclear, it is impossible for the board (or anyone else) to determine how the Fund has performed against those standards.

Recommendation: The board should request from Morgan Stanley the investment performance of the Fund as measured against both return standards stated in the Expected Annual Rate of Return section of the Investment Policy Statement.

G. Fund Investment Managers Payments to Morgan Stanley

As noted in our Interim First Report, investment consultants to pensions may be either independent or broker-affiliated. Independent investment consultants offer advice regarding investment managers which they maintain is objective and unbiased since they do not accept payments from the money managers they recommend to pensions. On the other hand, as noted by the SEC staff in 2005, many investment consultants offer, directly or through an affiliate or subsidiary, products and services to money managers that can give rise to potential conflicts of interest under the Investment Advisers Act that, at a minimum, need to be monitored and disclosed to plan fiduciaries.[29]

As awareness of the conflicts related to broker-affiliated consultants and the need for pensions to monitor such risks has grown nationally, many of the largest, most sophisticated pensions have migrated to independent investment consultants. Indeed, leading investment consulting firms such as Callan Associates, Mercer Consulting, and Wilshire Consulting all sold their brokerage affiliates in recent years in response to client concerns.

Plan fiduciaries that retain investment consultants that accept payments from investment managers they recommend face formidable obstacles in evaluating or monitoring such payments. Due to the immense variety of possible payment arrangements and the difficulty of compelling and verifying disclosures, plan fiduciaries are virtually forced to rely upon the unverified representations of their investment consultants regarding such payments. For

[29] Staff Report Concerning Examinations Of Select Pension Consultants May 16, 2005, The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission.

example, it is the recollection of Mr. Sugarman that his 2004-2005 investigation concluded with "the trustees taking Morgan Stanley at its word that these payments related to a company-wide relationship between the investment managers and Morgan Stanley and that the investment managers can't buy their way onto the approved list and that Glover never got any of the money."[30]

Florida firefighter pensions, such as the Fund, are specifically required under Section 175 Florida Statutes to use independent investment consultants that are not associated in any manner with the money managers to the Fund. Therefore, whether Morgan Stanley is in compliance with the applicable Florida Statutes is the relevant inquiry.

Our repeated requests for records regarding any compensation directly or indirectly paid to Morgan Stanley or any of its employees or agents by the Fund's investment managers have resulted in no additional information from Morgan Stanley regarding the nature and amounts of any such payments, including whether the payments have continued since 2004-2005.

On March 11, 2011, we received the following email from Allison Patton, Executive Director, Legal and Compliance Division at Morgan Stanley in response to our second request for information: "Morgan Stanley Smith Barney (MSSB) has provided you with its position on all of these requests in its response dated February 4, 2010. Please refer to that letter for responses to the requests you've underlined in the attachment to this email... As you know, the majority of the information you've requested relating to the Longboat Key Firefighters' Pension Fund accounts is not "required" to be provided to the client at their request and you should not mislead the Board into thinking that this Firm is wrongfully withholding information. However, because MSSB values its relationship with the Firefighters' Pension Fund, it has provided information above and beyond what is required. Providing that information to a valued client who is making good faith inquiries is something MSSB is willing to do. On the other hand, providing information to a "consultant" whose objective is to try and drum up what we believe is a frivolous lawsuit against MSSB is quite another matter. The Firm has reviewed your interim report and strongly disagrees with your characterization of events and interim findings."

In our opinion, Morgan Stanley, as a fiduciary to the Longboat Key Firefighters' Pension Fund, has an obligation to provide any and all information requested by the Fund regarding conflicts of interest, especially where required to demonstrate compliance with statutes applicable to the Fund, such as Florida Statutes Chapter 175. Given that public pension fund non-compliance with applicable law can have severe consequences for pensions, their participants and others, including taxpayers, any other interpretation of the fiduciary duty of advisers to public pensions would expose public pensions to unacceptable risks.

For example, it is our understanding from discussions with the State of Florida Division of Retirement that if the Fund is found to be noncompliant with the provisions of Florida Statutes

[30] Email from Mr. Sugarman dated March 24, 2011.

Chapter 175, such as determination may jeopardize the Fund's receipt of their premium tax monies. Such a potential outcome would be disastrous to the Fund, its participants and others.

For the above reasons we strongly disagree with Morgan Stanley that the majority of the information requested relating to payments by money managers of the Fund to Morgan Stanley, Morgan Stanley, as a fiduciary to the Fund, is not required to provide to the Fund at its request.

Recommendation: The board should determine whether the information provided by Morgan Stanley to date regarding the amounts and nature of payments to Morgan Stanley from the Fund's investment managers is adequate to demonstrate compliance by Morgan Stanley and the Fund with applicable fiduciary standards and law.

H. Compliance with All Applicable Law

In light of the independent investment consultant compliance issues initially raised by Mr. Sugarman in 2004-2005 and the additional compliance issues detailed in this report, Mr. Sugarman's suggestion of obtaining one or more written legal opinions regarding the Fund's compliance with all applicable laws, including Chapter 175 and 112, seems advisable in order to protect the Fund. As mentioned in the Interim First Report, the Florida Division of Retirement has declined to provide an opinion on the compliance issues and has indicated "the responsibility and liability rests with the board to determine if the consultant's response meets the requirement of the law."[31] As mentioned earlier, it is our understanding from discussions with the State of Florida Division of Retirement that noncompliance with the provisions of Chapter 175 and other applicable law may potentially jeopardize the Fund's receipt of their premium tax monies.

It is the recollection of Mr. Sugarman that his 2004-2005 investigation concluded with "the trustees taking Morgan Stanley at its word that these payments related to a company-wide relationship between the investment managers and Morgan Stanley and that the investment managers can't buy their way onto the approved list and that Glover never got any of the money."[32]

A review of the 2004-2006 minutes of the meetings of the Fund indicates that the final discussion of the investment consultant "pay-to-play" issues occurred at the May 25, 2005 meeting. According to the minutes of that meeting "Attorney Sugarman reported an agreement regarding consultant and fund manager relationships was forthcoming." The tape recording of the meeting indicates that Mr. Sugarman said he was continuing to correspond with the Fund's managers and working on an agreement with Morgan Stanley. He mentioned that the SEC was investigating such payment arrangements between pension consultants and managers and that

[31] Letter from Patricia Shoemaker, Benefits Administrator, Municipal Police Officers' and Firefighters" Retirement Funds, January 6, 2005.

[32] Email from Sugarman dated March 24, 2011.

he was planning on sending Morgan Stanley a questionnaire that Calpers, the nation's largest public fund, had created regarding pension consultant conflicts of interest. We have been unable to find any decision of the board indicating that the matter should not be further pursued and Mr. Sugarman has not provided us with any further explanation.

In order to protect the Fund, one or more written legal opinions could be obtained from Morgan Stanley; Morgan Stanley Trust; the Fund's investment managers or even a third party, such as qualified legal expert. If the Fund is clearly in compliance with applicable law, it should not be difficult to obtain the relevant legal opinion(s). On the other hand, if the Fund is noncompliant, given the passage of time since this issue was originally raised, action to remedy the deficiencies should be undertaken immediately.

Further, to monitor compliance matters going forward, it may be advisable to designate an individual (as is common in the investment management and securities industries) as the Fund's Compliance Director.

Recommendation: The board should consider whether to request one or more written legal opinions stating that the Fund is in compliance with applicable law.

Recommendation: The board should consider whether a Fund Compliance Director should be designated to monitor compliance issues.

I. Manager Contracts

The Client Services Agreement dated May 22, 2002 states that the Fund engages managers subject to the terms and conditions of the Agreement and also the Morgan Stanley Access Master Investment Managers Agreement ("MIMA") between the Manager and Morgan Stanley, "substantially in the form which is provided to the client in the ICS Disclosure Document."

The Client Services Agreement further provides that Morgan Stanley and the managers are permitted to amend the MIMA, "provided that no such amendment shall have a material adverse effect on the rights of the client."

The Client Services Agreement provides that Morgan Stanley may terminate a manager from the Morgan Stanley Access program without consulting clients and that if any of its investment managers is terminated by Morgan Stanley from the Access program the Fund will select a new manager.

Recommendation: The board should consider whether to request and review actual copies of all agreements between the Fund and its investment managers and between Morgan Stanley and the Fund's investment managers, including the MIMAs.

J. Fees

The Client Services Agreement dated May 22, 2002 states that the annual fee paid to Morgan Stanley shall be 87 basis points of the value of the account. The fee is payable quarterly in advance. (Recall that the previous contracts with SSB and Morgan Stanley provided that the investment consulting fee would be payable quarterly in arrears.) According to Mike Beasley, a Managing Director of SIS and nationally recognized pension consulting expert, "paying a consultant quarterly in advance is exceedingly rare."

According to the Agreement, except for certain fees and charges imposed by law with respect to securities transactions, the program fee of 87 basis points shall be in payment of all brokerage and custodial services, as well as Quarterly Performance Measurement Summary reports and the monitoring of the performance of the managers.

Morgan Stanley will pay a portion of the fee received from the client to the investment managers for managing the account (an annual fee of 35 basis points for fixed income accounts and 45 basis points for equity and balanced accounts); to Morgan Stanley Trust for custodial services (7 basis points); and a portion to the Morgan Stanley financial advisor for servicing the account.

The Client Service Agreement does not indicate whether the above fees to the managers and others are paid in advance or in arrears. It is extremely unusual for a traditional asset manager (as opposed to alternative managers) to be paid fees in advance; virtually all such managers are paid quarterly in arrears. Thus, it appears that Morgan Stanley holds the fees payable to investment managers that it receives from the Fund for approximately 3 months.

There is no "most favored nation's" clause in the Agreement. The purpose of "most favored nation" clauses in investment advisory contracts is to ensure that a fund receives the lowest rate an advisor offers similarly situated clients or accounts. These clauses are commonly used by public funds and, while not completely effective, can be beneficial by reducing the investment advisory fees funds pay. The Agreement simply states the fees may be different from fees charged other clients, depending on the extent of services provided and the cost of such services.

According to Town records, from January 9, 2002 through January 19, 2011, the Fund paid Morgan Stanley total fees of $593,188.06 pursuant to the Client Service Agreement. [33]

[33] According to the Town, from December 5, 2001 through August 8, 2010, the General employees plan paid Morgan Stanley total fees of $401,002.91. The Police officers plan, until just recently, had the money directly debited from its account and, as a result, those total amounts were not readily available.

Recommendation: The board should consider whether to continue paying fees to Morgan Stanley quarterly in advance or, consistent with industry practice, pay such fees quarterly in arrears.

Recommendation: The board should consider whether a "most favored nation's" provision in the agreement would be advisable.

K. Morgan Stanley and Individual Investment Consultant Disciplinary Records

FINRA BrokerCheck is a free tool to help investors research the professional backgrounds of current and former FINRA-registered brokerage firms and brokers. It should be the first resource pension boards turn to when choosing whether to do business or continue to do business with a particular broker or brokerage firm.

Through BrokerCheck, investors can:

- Search for both brokers and brokerage firms
- Obtain online delivery of a background report
- View explanatory information to help them better understand the content, context and source of the information provided
- See links to additional resources and tools

The information made available through BrokerCheck is derived from the Central Registration Depository (CRD®), the securities industry online registration and licensing database. Information in CRD is obtained through forms that brokers, brokerage firms and regulators complete as part of the securities industry registration and licensing process. BrokerCheck features professional background information on approximately 1.3 million current and former FINRA-registered brokers and 17,000 current and former FINRA-registered brokerage firms.

There are numerous Morgan Stanley entities registered as broker-dealers. The disciplinary record of Morgan Stanley & Co. Incorporated (CRD# 8209) indicates 2 pending and 292 final regulatory events; 3 final civil events and 35 final arbitrations. Pages 63 through 573 of the firm's BrokerCheck Report provide details regarding these matters.

Under "Certain Disciplinary Matters" on pages 35 through 39 in its 2010 Disclosure Document,[34] Morgan Stanley provides a list of certain legal and regulatory actions affecting MSSB. At the end of this section it is stated that MSSB's Form ADV Part I contains additional information about the firm's disciplinary history and is available from a Financial Advisor or Private Wealth Advisor.

The following individuals have been involved in providing services to the Fund over time.

[34]Exhibit P. Disclosure Document for Morgan Stanley Smith Barney LLC, November 2010, VIII. Certain Disciplinary Matters, pages 35-39.

Robert Alonza Glover aka Al Glover (CRD#223237) is registered both as a broker and as an investment advisory representative. His disciplinary record discloses one customer dispute involving an "untimely liquidation" that was settled for $16,484.00.

Robert S. Glover aka R. Scott Glover (CRD#2097073) is registered both as a broker and as an investment advisory representative. His disciplinary record discloses two customer disputes involving excessive risk and churning that were "denied."

Delmer J. Carter, Jr. aka Joe Carter (CRD#3067684) is registered both as a broker and as an investment advisory representative. His record discloses no history of customer disputes, disciplinary or regulatory events.

Timothy S. Hester (CRD#1983782) is registered both as a broker and as an investment advisory representative. His disciplinary record discloses 2 customer disputes involving misrepresentation and breach of fiduciary duty, respectively, that resulted in final customer awards of $7,950.00 and $37,500.00.

Recommendation: The board should review the disciplinary records related to Morgan Stanley and the individual Morgan Stanley investment consultants, including the FINRA BrokerCheck records, as well as the Form ADV disciplinary disclosures, on an annual basis.

L. Department of Labor

During the course of this review we were contacted by the U. S Department of Labor regarding conflicts of interest and disclosure practices of Morgan Stanley.

III. Campaign Contributions by Investment Advisers

Effective September 13, 2010, the Securities and Exchange Commission adopted a new rule under the Investment Advisers Act of 1940 that prohibits an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The new rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser, unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions. Additionally, the new rule prevents an adviser from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The Commission also adopted rule amendments that require a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees. The new rule and rule amendments address "pay to play" practices by investment advisers.

Our review of the Commissioner campaign contribution reports for 2001 through 2010 provided by the Town Clerk indicate no contributions by either Hester or Carter.

IV. Campaign Contributions by Others

Our review of the Commissioner campaign contribution reports for 2001 through 2010 provided by the Town Clerk indicate no contributions by others that raise concerns.

V. Trustees of the Fund; Town Officials, Officers, and Employees

Our review of the minutes of the meetings, contracts and other documents related to the Fund did not reveal any breaches of fiduciary duty involving trustees of the Fund, Town officials, officers, or employees.

VI. Legal Counsel

Sugarman & Susskind, P.A. serves as legal counsel to the Fund pursuant to a contract dated March 6, 2006, which provides payment of an hourly rate of $300.00.

According to the firm's website, the firm consists of "experienced employee benefits and labor law attorneys." Mr. Sugarman's letterhead indicates that he is a "Board Certified Labor and Employment Lawyer." Most public funds, including many of the largest, rely substantially or exclusively upon lawyers with labor and employment expertise to advise them upon matters related to the management of pension assets, as well as benefits and other labor issues. In our opinion, when decisions regarding management of pension assets are involved, access to counsel with expertise in investment company, investment advisory and securities trading regulation and business practices may be beneficial. (On the other hand, such investment management expertise may be irrelevant when labor and benefits matters are at issue.)

As we have discussed with the board at the January 19, 2011 special meeting, prior to accepting this engagement we indicated to the board and Sugarman & Susskind that, in our opinion, Sugarman & Susskind was subject to a conflict of interest in this matter.[35] On October 4, 2010 we received an email from Mr. Sugarman indicating that he disagreed but would discuss our concerns with Chairman Tanner.

It is unclear to us whether all communications between Sugarman & Susskind, P.A. and Morgan Stanley related to the Fund have been provided to the board. We have also suggested to Mr. Sugarman and the board that, for educational purposes, Mr. Sugarman share with the board information regarding a class action he is involved with on behalf of Florida public funds alleging pension consultant conflicts of interest, as well as information regarding approximately 30 other individual cases involving Florida pensions alleging similar conflicts.[36]

[35] See September 2, 2010 and September 30, 2010 emails to Sugarman & Susskind.
[36] March 11, 2011 email to Sugarman.

Recommendation: The board should request from Sugarman & Susskind all information related to Morgan Stanley and the Fund.

Recommendation: The board should consider whether Sugarman & Susskind may have a conflict of interest with respect to matters discussed herein.

Recommendation: The board should consider whether information regarding legal actions alleging pension consultant conflicts of interest involving Florida public funds may be of educational value.

VII. Conclusions

As noted throughout the report, information that has yet to be provided should be obtained and the board should determine what, if any, further action it wishes to take based upon the recommendations contained in this report.

Edward Siedle
President
Benchmark Financial Services, Inc.
April 18, 2011