Report on Common Fund Cites Warning Signs

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Common Fund, a money-management giant that was embarrassed last year by a $138 million trading loss, missed at least three warnings that could have helped it head off the problem, a new report suggests.

The Westport, Conn., Common Fund manages about $19 billion for some 1,400 colleges and other educational institutions. About 50 members have withdrawn lately, mainly as a result of the trading loss, which Common Fund blamed on a rogue trader at a subcontractor.

According to a report for Common Fund members prepared by the New York law firm Cravath, Swaine & Moore, Common Fund management deserves some criticism for failing adequately to supervise one of its subcontractors, First Capital Strategists of York, Pa. First Capital has halted its operations.

But the report, which was commissioned by Common Fund, saves its harshest criticism for other parties: Kent Ahrens, the alleged "rogue trader" who caused the loss, Mr. Ahrens's supervisors at First Capital Strategists, and **KPMG Peat Marwick**, the accounting firm Common Fund used to audit First Capital Strategists.

Common Fund previously had sued Mr. Ahrens. Yesterday it filed suit in U.S. district court in Manhattan against First Capital Strategists and KPMG Peat Marwick. The suit seeks $137.6 million, plus possible additional damages. First Capital declined to comment on the lawsuit. A spokesman for KPMG didn't return a call seeking comment.

The Cravath report says Common Fund didn't supervise First Capital as closely as it should have, partly because of the trust Common Fund employees had in their former colleague, Jack McCollum. Mr. McCollum worked at Common Fund for about nine years before he became a partner at First Capital Strategists in 1981. The report cites "the Common Fund's comfortable and trusting relationship with McCollum and his partners," and gives as an example Mr. McCollum's marriage in November 1992 to Mary Harkless, who was vice president of fund operations for Common Fund until December 1993.

Common Fund doesn't manage colleges' money directly: It farms the money out to a network of some three dozen money managers that act as subcontractors. First Capital Strategists ran Common Fund's securities-lending program, and invested the proceeds in an index-arbitrage strategy that was supposed to be indifferent to the stock market's direction.

According to Common Fund and First Capital, Mr. Ahrens subverted the strategy, turning it into an ill-advised bet that the market would fall. Mr. Ahrens has made no public statements and hasn't been charged by authorities.

The report mentions some warning signs that, if heeded, might have alerted the giant fund to problems at First Capital

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Strategists.

One potential warning came in June 1981, when Edward Fox, then a Common Fund board member, asked that the securities-lending program be halted until better controls were developed. According to board minutes, "Mr. Fox expressed concerns that procedures, controls and systems do not appear to have grown along with the activity. Therefore, he views the operation as one where the risk is not defined or control sufficiently."

However, the board voted down Mr. Fox's suggestion. The Cravath report says, "It appears that, in part as a result of this board action, Mr. Fox ultimately resigned from the board of trustees."

A second possible warning came in the mid-1980s when Princeton University, as the report put it, "severed its relationship with First Capital at least in part because First Capital had, on several occasions, exceeded counterparty position limits imposed by Princeton."

However, the Cravath report says, Common Fund didn't know about Princeton's action until later, and "Common Fund's management appears to have believed that the severance occurred for reasons unrelated to the internal control structure at First Capital."

Another Warning Signal

A third possible red flag waved in March 1993. The available evidence, the report says, "suggests that First Trust (the custodian for the securities-lending program) was having difficulty because information received from First Capital concerning options trades did not match information received from the counterparty brokers."

"It appears," the report goes on, "that Keith Cunningham of First Capital proposed to solve this problem by relieving First Trust of any responsibility for recording options transactions or reconciling Common Fund option positions." Naturally, First Trust wanted to know if this "solution" was authorized by Common Fund. "Ms. Harkless, apparently without the knowledge of any other person at The Common Fund, provided that authorization in writing. It appears this change in procedure may have facilitated to some extent Ahrens's ability to hide his wrongdoing."

Ms. Harkless couldn't be reached for comment.

Of the accountant's role, Cravath wrote, "It is very difficult for us to understand how Peat Marwick, if it was carrying out its responsibilities faithfully and competently, could have remained unaware of the fundamentally defective and inadequate accounting, control and reporting environment. . . ."

People close to Common Fund say the harsh language appeared to presage yesterday's lawsuit against the accounting firm. They note that KPMG Peat Marwick has much deeper pockets than Mr. Ahrens or First Capital Strategists.

David K. Storrs resigned this month as president of Common Fund, though he will remain on board for a time to help resolve the First Capital tangle. A spokesman described that resignation yesterday as "a mutual decision" by Mr. Storrs and Common Fund's board.

Also departing — though their departures weren't announced — are Gary Watson, chief operating officer, and Paul Jacobello, controller for a Common Fund unit called Endowment Advisers Inc. Both men had joined Common Fund during the past two years, after previously working for KPMG Peat Marwick on the Common Fund account.